

2009

IFRS Foundation: Training Material for the *IFRS[®] for SMEs*

Module 17 – Property, Plant and Equipment



IFRS Foundation: Training Material for the *IFRS[®] for SMEs*

including the full text of
Section 17 *Property, Plant and Equipment*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

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Contents

INTRODUCTION	1
Learning objectives	1
<i>IFRS for SMEs</i>	2
Introduction to the requirements	2
REQUIREMENTS AND EXAMPLES	3
Scope	3
Recognition	6
Measurement at recognition	8
Measurement after initial recognition	11
Depreciation	11
Depreciable amount and depreciation period	12
Depreciation method	16
Impairment	17
Derecognition	19
Disclosures	21
SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS	25
COMPARISON WITH FULL IFRSs	28
TEST YOUR KNOWLEDGE	29
APPLY YOUR KNOWLEDGE	34
Case study 1	34
Answer to case study 1	35
Case study 2	37
Answer to case study 2	39

Module 17 – Property, Plant and Equipment

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB). The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the accounting and reporting of property, plant and equipment in accordance with Section 17 *Property, Plant and Equipment* of the *IFRS for SMEs*. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for property, plant and equipment. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for property, plant and equipment in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for property, plant and equipment in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your ability to account for property, plant and equipment in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able:

- to distinguish items of property, plant and equipment from other assets of an entity
- to identify when items of property, plant and equipment qualify for recognition in financial statements
- to measure items of property, plant and equipment on initial recognition and subsequently
- to present and disclose property, plant and equipment in financial statements
- to identify when an item of property, plant and equipment is to be derecognised or transferred to another classification of asset, and account for that derecognition or transfer
- to demonstrate an understanding of the significant judgements that are required in accounting for property, plant and equipment.

Module 17 – Property, Plant and Equipment

IFRS for SMEs

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance, which includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. Those appendices are non-mandatory guidance.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. The objective of Section 17 is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can see information about an entity's investment in its property, plant and equipment and the changes in such investment. The main issues that arise are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

The section requires an entity to account for property, plant and equipment at its cost at initial recognition and subsequently at cost less any accumulated depreciation and accumulated impairment losses.

An item of property, plant and equipment is depreciated over its expected useful life. The depreciable amount takes into account the expected residual value at the end of the asset's useful life. The residual value, depreciation method and depreciation rate are reviewed if there is an indication of a significant change in expectations since the last annual reporting date. Furthermore, at each reporting date, an entity shall assess whether there is any indication that any item of property, plant and equipment may be impaired (ie carrying amount exceeds estimated fair value less costs to sell). If any such indication exists, that item of property, plant and equipment is tested for impairment.

When an item of property, plant and equipment is disposed of, the gain or loss on disposal is included in profit or loss.

Module 17 – Property, Plant and Equipment

REQUIREMENTS AND EXAMPLES

The contents of Section 17 *Property, Plant and Equipment* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. Those terms are in **bold type** the first time they appear in the text of Section 17. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in **bold italics**. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope

- 17.1 This section applies to accounting for **property, plant and equipment** and **investment property** whose fair value cannot be measured reliably without undue cost or effort. Section 16 *Investment Property* applies to investment property whose fair value can be measured reliably without undue cost or effort.

Notes

Property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both is investment property (see Section 16 *Investment Property*). However, investment property whose fair value cannot be measured reliably without undue cost or effort on an ongoing basis is accounted for in accordance with the requirements in Section 17 *Property, Plant and Equipment*.

Investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. See paragraph 16.4 for the classification of mixed use property.

Judgement is sometimes needed to determine whether a property qualifies as investment property. For example, when an entity provides ancillary services to the occupants of a property it holds, it treats the property as investment property if the services are insignificant to the arrangement as a whole.

The *IFRS for SMEs* does not specify how to classify land that is held for an undetermined purpose. In developing its accounting policy for land acquired for an undetermined purpose an entity may (but is not required to) look to the requirements of full IFRSs (see paragraph 10.6 of the *IFRS for SMEs*). IAS 40 *Investment Property* specifies that land acquired for an undetermined purpose is classified as investment property (see IAS 40 paragraph 8(b)) because a subsequent decision to use such land as inventory or for development as owner-occupied property would be an investment decision (see Basis for Conclusions on IAS 40 paragraph B67(b)(ii)).

Module 17 – Property, Plant and Equipment

- 17.2 Property, plant and equipment are tangible assets that:
- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and
 - (b) are expected to be used during more than one period.

Examples – items of property, plant and equipment

Ex 1 An entity owns a factory building in which it manufactures its products.

The building is classified as an item of property, plant and equipment. It is a physical asset used in the production of goods that is expected to be used during more than one reporting period.

Ex 2 An entity owns a building occupied by its administrative staff.

The building is classified as an item of property, plant and equipment. It is a physical asset used for administrative purposes that is expected to be used during more than one reporting period.

Ex 3 An entity (parent) holds a building to earn rentals under an operating lease from its subsidiary. The subsidiary uses the building as a retail outlet for its products.

In the parent's consolidated financial statements (see paragraph 9.2) the building is classified as an item of property, plant and equipment. The consolidated financial statements present the parent and its subsidiary as a single entity. The consolidated entity uses the building for the supply of goods over more than one accounting period.

In the separate financial statements of the parent (if prepared, see paragraph 9.24) the building is classified as an investment property (see paragraph 16.2) and accounted for in accordance with Section 16 *Investment Property*. It is a property held to earn rentals. However, if the fair value of the investment property cannot be measured reliably without undue cost or effort on an ongoing basis, the parent accounts for the property as property, plant and equipment in accordance with the requirements of Section 17 (see paragraph 17.1).

Ex 4 An entity owns a fleet of motor vehicles. The vehicles are used by the sales staff in the performance of their duties.

The motor vehicles are classified as items of property, plant and equipment. They are physical assets used in the supply of goods during more than one reporting period.

Ex 5 An entity owns a motor vehicle for the exclusive business and private use of its chief financial officer.

The motor vehicle is classified as an item of property, plant and equipment. It is a physical asset used in the administration of the entity during more than one reporting period.

Module 17 – Property, Plant and Equipment

Ex 6 An entity purchases, for one combined payment, an existing building and the remaining 80-year interest in a 100-year right to use the land on which the building sits (freehold ownership of land is not possible in that jurisdiction). The building is occupied by the entity's administrative staff.

The purchase price is split between the land use right and the building on the basis of the relative fair values of the two assets. The land use right is accounted for as an operating lease under Section 20 (see example 9) and the building is accounted for as property, plant and equipment under Section 17.

17.3 Property, plant and equipment does not include:

- (a) biological assets related to agricultural activity (see Section 34 *Specialised Activities*), or
- (b) mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources.

Notes

Property, plant and equipment also excludes assets held for sale in the ordinary course of business, assets in the process of production for such sale, and assets in the form of materials or supplies to be consumed in the production process or in the rendering of services. Such assets are inventories (see Section 13 *Inventories*).

Intangible assets are also not items of property, plant and equipment. They are accounted for in accordance with Section 18 *Intangible Assets other than Goodwill*.

Examples – not items of property, plant and equipment

Ex 7 An entity owns a herd of cattle that form the breeding stock of its agricultural activities. The entity also owns a tractor and trailer used to transport feed to the cattle.

Although the cattle arguably meet the definition of property, plant and equipment—they are tangible assets used in the production of calves in more than one accounting period—they are accounted for as biological assets in accordance with paragraph 34.2. They are outside the scope of Section 17 *Property, Plant and Equipment* (see paragraph 17.3(a)).

The tractor and trailer are classified as items of property, plant and equipment. They are physical assets used in the supply of goods during more than one reporting period. As the tractor and trailer are not biological assets (paragraph 34.2 does not apply to them).

Ex 8 An entity acquired a licence to operate a taxi in a major city.

The taxi licence is not an item of property, plant and equipment. It is an intangible asset (see Section 18 *Intangible Assets other than Goodwill*).

Module 17 – Property, Plant and Equipment

Ex 9 An entity pays a government for a 100-year right to use the land on which it plans to construct a building (freehold ownership of land is not possible in that jurisdiction).

The payment to the government is treated as a prepayment on a lease (prepaid expense). The lease would be classified as an operating lease (because it does not transfer substantially all the risks and rewards incidental to ownership). The operating lease would be accounted for under Section 20 *Leases* except in the special case in which it is classified as investment property and the requirements of paragraph 16.3 are followed.

Recognition

17.4 An entity shall apply the recognition criteria in paragraph 2.27 in determining whether to recognise an item of property, plant or equipment. Therefore, the entity shall recognise the cost of an item of property, plant and equipment as an asset if, and only if:

- (a) it is **probable** that future economic benefits associated with the item will flow to the entity, and
- (b) the cost of the item can be measured reliably.

17.5 Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment are property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are considered property, plant and equipment.

Examples – spare parts and servicing equipment

Ex 10 An entity manufactures chemicals. It services its manufacturing plant using specialised servicing equipment that is unique to the servicing requirements of its plant.

The servicing equipment is classified as property, plant and equipment. It can be used only in connection with the entity's plant and is expected to be used in more than one accounting period.

Ex 11 An entity manufactures chemicals. It services its manufacturing plant using common low value tools acquired from a local hardware store.

The servicing tools are not items of property, plant and equipment. They are inventories (see Section 13 *Inventories*). The tools are not unique to the servicing requirements of the entity's plant.

Ex 12 A private hospital has installed two identical back-up generators. The first back-up generator provides electricity when the supply from the national grid is interrupted. The second back-up generator will be used in the unlikely event that the first back-up generator fails when the supply from the national grid is interrupted.

Module 17 – Property, Plant and Equipment

Both back-up generators are items of property, plant and equipment. The stand-by equipment is expected to be used in more than one accounting period, albeit irregularly.

17.6 Parts of some items of property, plant and equipment may require replacement at regular intervals (eg the roof of a building). An entity shall add to the **carrying amount** of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the replacement part is expected to provide incremental future benefits to the entity. The carrying amount of those parts that are replaced is **derecognised** in accordance with paragraphs 17.27–17.30. Paragraph 17.16 provides that if the major components of an item of property, plant and equipment have significantly different patterns of consumption of economic benefits, an entity shall allocate the initial cost of the asset to its major components and **depreciate** each such component separately over its **useful life**.

Example – replacement parts

Ex 13 **An entity that manufactures agricultural chemicals is required to have the protective lining of its chemical processing plant inspected for corrosion at six-month intervals. If an inspection reveals damage to the lining the entity is required to replace the lining immediately. Experience has shown that linings require replacement, on average, every four years. The entity depreciates linings on the straight line basis over their estimated four-year useful life to a nil residual value. The other parts of the plant are depreciated on the straight-line basis over their estimated 20-year useful life.**

During the current reporting period an inspection revealed that a three-year-old lining with a carrying amount of CU100,000⁽¹⁾ was damaged. The lining was immediately replaced at a cost of CU420,000.

To recognise the replacement lining the entity must record CU420,000 as an asset—property, plant and equipment. The new lining (asset) will be recognised as an expense (depreciation) in profit or loss evenly over its estimated four-year useful life.

During the current reporting period (ie when the old lining was removed), the entity must record an expense in profit or loss of CU100,000 for the derecognition of the damaged lining (see paragraph 17.30).

17.7 A condition of continuing to operate an item of property, plant and equipment (eg a bus) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous major inspection (as distinct from physical parts) is derecognised. This is done regardless of whether the cost of the previous major inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

⁽¹⁾ In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

Module 17 – Property, Plant and Equipment

Example – inspections that are a condition of operating an asset

Ex 14 An entity that operates an executive aviation service is required to have its jet aircraft inspected for faults by the national aviation authorities every two years. An inspection was made halfway through the current annual reporting period at a cost of CU20,000.

The entity must recognise an asset (property, plant and equipment) of CU20,000 for the inspection. The inspection asset must be recognised as an expense (depreciation) in profit or loss evenly over its estimated two-year useful life (ie CU5,000 expense during the current reporting period).

17.8 Land and buildings are separable assets, and an entity shall account for them separately, even when they are acquired together.

Measurement at recognition

17.9 An entity shall measure an item of property, plant and equipment at initial recognition at its cost.

Elements of cost

17.10 The cost of an item of property, plant and equipment comprises all of the following:

- (a) its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These can include the costs of site preparation, initial delivery and handling, installation and assembly, and testing of functionality.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17.11 The following costs are not costs of an item of property, plant and equipment, and an entity shall recognise them as an expense when they are incurred:

- (a) costs of opening a new facility.
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities).
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training).
- (d) administration and other general overhead costs.
- (e) **borrowing costs** (see Section 25 *Borrowing Costs*).

17.12 The income and related expenses of incidental operations during construction or development of an item of property, plant and equipment are recognised in profit or loss if

Module 17 – Property, Plant and Equipment

those operations are not necessary to bring the item to its intended location and operating condition.

Example – measurement at initial recognition

Ex 15 On 1 January 20X1 an entity purchased an item of equipment for CU600,000, including CU50,000 refundable purchase taxes. The purchase price was funded by raising a loan of CU605,000 (including CU5,000 loan raising fees). The loan is secured against the equipment.

In January 20X1 the entity incurred costs of CU20,000 in transporting the equipment to the entity's site and CU100,000 in installing the equipment at the site. At the end of the equipment's 10-year useful life the entity is required to dismantle the equipment and restore the land upon which the factory is built. The present value of the cost of dismantling the equipment and restoring the environment is estimated to be CU100,000.

In January 20X1 the entity's engineer incurred the following costs in modifying the equipment so that it can produce the products manufactured by the entity:

- Material – CU55,000
- Labour – CU65,000
- Depreciation of plant and equipment used to perform the modifications – CU15,000

In January 20X1 the entity's production staff were trained in how to operate the new item of equipment. Training costs included:

- Cost of an expert external instructor – CU7,000
- Labour – CU3,000

In February 20X1 the entity's production team tested the equipment and the engineering team made further modifications necessary to get the equipment to function as intended by management. The following costs were incurred in the testing phase:

- Material, net of CU3,000 recovered from the sale of the scrapped output – CU21,000
- Labour – CU11,000
- Depreciation of plant and equipment used to perform the modifications – CU5,000

The equipment was ready for use on 1 March 20X1. However, because of low initial order levels the entity incurred a loss of CU23,000 on operating the equipment during March. Thereafter the equipment operated profitably.

What is the cost of the equipment at initial recognition?

Module 17 – Property, Plant and Equipment

Description	Calculation or reason	CU	Reference to IFRS for SMEs
Purchase price	CU600,000 purchase price less CU50,000 refundable purchase taxes	550,000	17.10(a)
Loan raising fee	Included in the measurement of the liability	-	11.18
Transport cost	Directly attributable expenditure	20,000	17.10(b)
Installation costs	Directly attributable expenditure	100,000	17.10(b)
Environmental restoration costs	The obligation to dismantle and restore the environment arose from the installation of the equipment	100,000	17.10(c)
Preparation costs	CU55,000 material + CU65,000 labour + CU15,000 depreciation	135,000	17.10(b)
Training costs	Recognised as expenses in profit or loss. The equipment was capable of operating in the manner intended by management without incurring the training costs.	-	5.4
Cost of testing	CU21,000 material (ie net of the CU3,000 recovered from the sale of the scrapped output) + CU11,000 labour + CU5,000 depreciation	37,000	17.10(b)
Operating loss	Recognised as expenses in profit or loss	-	5.4
Borrowing costs	Recognised as expenses in profit or loss	-	17.11(e) & 25.2
Cost of equipment		942,000	

Measurement of cost

17.13 The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the cost is the **present value** of all future payments.

Example – cost when payment is deferred

Ex 16 An entity acquired a plant for CU2,000,000 on two-years' interest-free credit. An appropriate discount rate is 10 per cent per year.

The cost of the plant is CU1,652,893 (ie the present value of the future payment).

Calculation: CU2,000,000 future payment $\times 1/(1.1)^2$.

Note: The unwinding of the discount results in interest expense recognised in profit or loss respectively of CU165,289 and CU181,818 in the first and second 12-month period after the sale. Furthermore, two years after the sale, the liability of CU2,000,000 (ie CU1,652,893 + CU165,289 + CU181,818) is derecognised upon settlement of the debt.

Exchanges of assets

17.14 An item of property, plant or equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. An entity shall measure the cost of the acquired asset at **fair value** unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. In that case, the asset's cost is measured at the carrying amount of the asset given up.

Module 17 – Property, Plant and Equipment

Measurement after initial recognition

17.15 An entity shall measure all items of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated **impairment losses**. An entity shall recognise the costs of day-to-day servicing of an item of property, plant and equipment in profit or loss in the period in which the costs are incurred.

Example – measurement after initial recognition

Ex 17 On 1 January 20X1 an entity acquired a plant for CU500,000. Management estimates the useful life of the plant as five years measured from the date of acquisition. Furthermore, it estimates the residual value of the plant as CU100,000.

Management judges that the straight-line method reflects the pattern in which it expects to consume the plant's future economic benefits.

At 31 December 20X1 the plant was damaged and its recoverable amount was estimated as CU300,000.

What is the carrying amount of the plant on 31 December 20X1?

Description	Calculation or reason	CU	Reference to IFRS for SMEs
Cost	Purchase price	500,000	17.10(a)
Residual value	Estimated by management	(100,000)	17.18
Depreciable amount	Cost less residual value	400,000	17.18
Depreciation per year	CU400,000 depreciable amount ÷ 5 years useful life	(80,000)	17.22
Carrying amount before impairment	CU500,000 cost less CU80,000 accumulated depreciation	420,000	
Impairment	Carrying amount before impairment (CU420,000) less fair value less costs to sell (CU300,000)	(120,000)	17.24
Carrying amount	Impaired to fair value less costs to sell	300,000	17.15

Depreciation

17.16 If the major components of an item of property, plant and equipment have significantly different patterns of consumption of economic benefits, an entity shall allocate the initial cost of the asset to its major components and depreciate each such component separately over its useful life. Other assets shall be depreciated over their useful lives as a single asset. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated.

Module 17 – Property, Plant and Equipment

Example – depreciation of major components

Ex 18 On 1 January 20X1 an entity acquired an item of heavy machinery for CU600,000. The machine is made up of three components of equal value: (i) fixed parts—management estimates fixed parts have a 25-year useful life with no residual value; (ii) moving parts—management estimates moving parts have a five-year useful life with no residual value; and (iii) a foundation—management estimates the foundation has a 25-year useful life with no residual value. Furthermore, management judges that the straight-line method reflects the pattern in which the entity expects to consume the future economic benefits of all components of the machine.

The entity must allocate the CU600,000 initially recognised to the three components of the machine. However, fixed parts and the foundation may be grouped together in determining the depreciation charge as these components have the same useful life and both must be depreciated on the straight-line method. One-third of the cost (or CU200,000) will be allocated to the moving parts and two-thirds of the cost (or CU400,000) will be allocated to the combined foundation and fixed parts.

17.17 The depreciation charge for each period shall be recognised in profit or loss unless another section of this IFRS requires the cost to be recognised as part of the cost of an asset. For example, the depreciation of manufacturing property, plant and equipment is included in the costs of inventories (see Section 13 *Inventories*).

Example – depreciation charge allocated to the cost of an asset

Ex 19 On 1 January 20X1 an entity acquired a machine for CU1,200,000. Management estimates the machine has a 10-year useful life (measured from the date of acquisition) and a nil residual value. Furthermore, management judges that the straight-line method reflects the pattern in which the entity expects to consume the machine's future economic benefits.

In 20X1 the machine was used to produce inventory for eight months. Thereafter, the machine was used to manufacture components of a new item of plant being constructed by the entity. The new plant will be used by the entity to manufacture a new product line.

Depreciation for the year is CU120,000 (calculation: CU1,200,000 ÷ 10 years). In 20X1 the entity must allocate CU80,000 (ie 8/12 months x CU120,000) to the cost of inventories manufactured in 20X1 and CU40,000 to the cost of the new plant undergoing construction (ie 4/12 months x CU120,000).

Depreciable amount and depreciation period

17.18 An entity shall allocate the **depreciable amount** of an asset on a systematic basis [*Refer: paragraph 17.22*] over its useful life.

17.19 Factors such as a change in how an asset is used, significant unexpected wear and tear, technological advancement, and changes in market prices may indicate that the residual

Module 17 – Property, Plant and Equipment

value or useful life of an asset has changed since the most recent annual **reporting date**. If such indicators are present, an entity shall review its previous estimates and, if current expectations differ, amend the residual value, depreciation method or useful life. The entity shall account for the change in residual value, depreciation method or useful life as a **change in an accounting estimate** in accordance with paragraphs 10.15–10.18.

Notes

The depreciable amount of an item of property, plant and equipment is its cost, or other amount substituted for cost (in the financial statements), less its residual value.

The residual value of an item of property, plant and equipment is the estimated amount that an entity would currently obtain from disposal of the item, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Example – revised assessment of depreciation

Ex 20 On 1 January 20X1 an entity acquired an item of machinery for CU500,000. Management estimated the useful life of the machine as 20 years and its residual value as nil. Furthermore, management believed that the straight-line method reflects the pattern in which it expects to consume the machine’s future economic benefits.

At the entity’s 31 December 20X5 financial year-end management’s assessments of the machine changed. It now estimates the useful life of the machine as 25 years (measured from the date of acquisition) and its residual value as CU100,000. Management continues to believe that the straight-line method reflects the pattern in which it expects to consume the machine’s future economic benefits.

How must the entity account for the revised assessment of the machine in the year ended 31 December 20X5?

Dr	Profit or loss (depreciation expense)	CU14,286 ^(a)	
	Cr Accumulated depreciation		CU14,286

To record depreciation expense for the year ended 31 December 20X5.

- (a) $(CU400,000^{(b)} \text{ less } CU100,000 \text{ residual value}) \div 21 \text{ years' remaining useful life at the beginning of the current reporting period} = CU14,286$
- (b) $CU500,000 \text{ cost less } (4 \text{ years} \times CU25,000^{(c)} \text{ annual depreciation}) = CU400,000 \text{ carrying amount at 1 January 20X5 (ie 31 December 20X4)}$
- (c) $\text{Original annual depreciation} = CU500,000 \div 20 \text{ years} = CU25,000$

17.20 Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognised. Depreciation does not cease when the asset becomes idle or is retired from active use

Module 17 – Property, Plant and Equipment

unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Example – commencing and ceasing depreciation

Ex 21 On 1 January 20X1 an entity acquired a machine for CU3,000,000. Management estimated the useful life of the machine as 20 years and its residual value as nil. Furthermore, management believe that the straight-line method reflects the pattern in which it expects to consume the machine's future economic benefits.

The machine was installed and ready for use as intended by management by 1 February 20X1. However, because of unexpected delays in the retraining of staff to operate the machine, production began on 1 March 20X1.

From 1 June 20X3 to 30 July 20X3 the machine was idle because the employees that operate the machine had embarked on industry-wide industrial action in the form of a stay away.

On 30 September 20X5 the entity's owner manager decided to dispose of the machine. On 15 October 20X5 he informed the machine operators of his decision and advertised the machine for sale in the local and industry press. On 1 November 20X5 the entity entered into negotiations with an independent third party for the sale of the machine. A binding sale agreement was signed on 2 February 20X6 and the risks and rewards of ownership of the machine were also transferred from the entity to the buyer on this date.

When must the entity start to depreciate the machine?

The entity must start depreciating the machine on 1 February 20X1, when it was installed in the entity's factory and in a condition necessary for it to be capable of operating in the manner intended by management.

When must the entity cease depreciating the machine?

The entity must cease depreciating the machine when the machine is derecognised (ie when it is disposed of on 2 February 20X6).

Note—the machine continues to be depreciated after its carrying amount will be recovered principally through a sale transaction. However, in accordance with paragraph 27.9(f), a plan to dispose of an asset before the previously expected date triggers an impairment test (see paragraph 17.26).

Must the entity temporarily suspend depreciation of the machine between 1 June and 30 July 20X3?

No, the entity must not temporarily suspend depreciating the machine when it is idle. Depreciation of an asset ceases only when the asset is derecognised or it is fully depreciated. However, under usage methods of depreciation (eg units of production method) the depreciation charge can be nil while there is no production.

17.21 An entity shall consider all the following factors in determining the useful life of an asset:

Module 17 – Property, Plant and Equipment

- (a) the expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
- (b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.
- (c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.
- (d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

Examples – useful life of an asset

Ex 22 As part of their remuneration package an entity provides each senior manager with the private use of a luxury motor vehicle of the manager's choice. The executive motor vehicles are replaced every two years irrespective of usage.

The entity sells and replaces its luxury motor vehicle fleet every two years when the vehicles are expected to be economically usable by one or more users for at least another three years.

The useful life of the vehicles is two years. The fact that the vehicles could be operated for five years is not relevant to the assessment of their useful life. Useful life is the period over which the vehicles are expected to be available for use by the entity (ie two years).

Ex 23 An entity does not service its equipment regularly. With regular servicing the equipment would be available for use for five years. However, the expected equipment servicing pattern is expected to render the equipment unusable in three years.

The useful life of the equipment is three years (ie the period over which the equipment is expected to be available for use by the entity taking account of expected levels of servicing). The fact that regular servicing would extend the life of the equipment to five years is irrelevant when the entity does not expect to undertake regular servicing.

Ex 24 An entity's equipment used to manufacture a patented drug is expected to be capable of producing the drug for ten years. However, the entity expects to stop manufacturing the drug and scrap the equipment after five years of production when its patent expires and low cost generic drugs are expected to render the entity's manufacturing of this drug unprofitable.

The useful life of the equipment is five years (ie the period over which the equipment is expected to be available for use by the entity taking account of expected production patterns). The fact that the equipment is expected to be fit for purpose for ten years is irrelevant when the entity expects to stop operating the equipment after five years.

Ex 25 An entity has the right of use of an item of equipment in accordance with the terms of a finance lease. The equipment is capable of operating for 15 years. However,

Module 17 – Property, Plant and Equipment

the lease term is 13 years and the entity is required to return the equipment to the lessor at the end of the lease term.

The useful life of the equipment is 13 years—the period over which the equipment is expected to be available for use by the entity taking account of limits imposed by the lease (ie the 13-year lease term). The fact that equipment is expected to be fit for purpose for an additional two years is irrelevant, as the entity does not expect to use the asset for that additional two-year period.

Depreciation method

17.22 An entity shall select a depreciation method that reflects the pattern in which it expects to consume the asset's future economic benefits. The possible depreciation methods include the straight-line method, the diminishing balance method and a method based on usage such as the units of production method.

Notes

The depreciation method used is not a free choice. The depreciation method chosen is that which best matches the benefits. Furthermore, this might not be the same method as allowed for tax purposes.

Examples – depreciation method

Ex 26 An entity uses an item of machinery in the production of hazardous chemicals. Industry regulations limit the output of the machine to 1,000,000 litres, after which the machine must be decommissioned, decontaminated and recycled. The entity projects that the output of the machine will reach 1,000,000 litres within four years of its acquisition, at which time the machine will be decommissioned.

The unit of production method is probably the most appropriate depreciation method for the entity to apply in depreciating the machine. This method reflects the pattern in which the entity expects to consume the asset's future economic benefits. Using this method $1/1,000,000$ of the cost of the machine would be included in the cost of each litre of chemical produced by the machine. If usage varied from period to the next, the straight-line method of depreciation would not reflect the pattern in which it expects to consume the machine's future economic benefits.

Ex 27 As part of their remuneration package an entity provides each senior manager with the private use of a luxury motor vehicle of the manager's choice. The executive motor vehicles are replaced every two years irrespective of usage.

The straight-line method is probably the most appropriate depreciation method for the entity to apply in depreciating the executive motor vehicles. This method reflects the pattern in which the entity expects to consume the asset's future economic benefits. Using this method $\frac{1}{2}$ (ie 1 out of 2 years) of the depreciable amount of the vehicle would be included in depreciation expense each year.

Module 17 – Property, Plant and Equipment

17.23 If there is an indication that there has been a significant change since the last annual reporting date in the pattern by which an entity expects to consume an asset's future economic benefits, the entity shall review its present depreciation method and, if current expectations differ, change the depreciation method to reflect the new pattern. The entity shall account for the change as a change in an accounting estimate in accordance with paragraphs 10.15–10.18.

Examples – change in depreciation method

Ex 28 On 1 January 20X1 an entity acquired a machine for CU500,000. Management estimated the machine's residual value as nil. Furthermore, management believed that the diminishing balance method computed at the rate of 8 per cent per year reflects the pattern in which the entity expects to consume the machine's future economic benefits.

At the entity's 31 December 20X5 financial year-end its assessment of the machine changed. Management now estimates that the straight-line method of depreciation, at the rate of 6 per cent per year, better reflects the pattern in which the entity expects to consume the machine's remaining future economic benefits.

How must the entity account for the revised assessment of its machine for the year ended 31 December 20X5?

Dr	Profit or loss (depreciation expense)	CU21,492 ^(a)	
	Cr Accumulated depreciation		CU21,492

To record depreciation expense for the year ended 31 December 20X5.

- (a) $CU358,196^{(b)} \times 6\% = CU21,492$
- (b) $CU500,000 \text{ cost} \times 92\%$ (ie 8% depreciation per year) = CU 460,000 carrying amount at 31/12/20X1. $CU460,000 \times 92\% = CU423,200$ carrying amount at 31/12/20X2. $CU423,200 \times 92\% = CU389,344$ carrying amount at 31/12/20X3. $CU389,344 \times 92\% = CU358,196$ carrying amount at 31/12/20X4.

Impairment

Recognition and measurement of impairment

17.24 At each reporting date, an entity shall apply Section 27 *Impairment of Assets* to determine whether an item or group of items of property, plant and equipment is impaired and, if so, how to recognise and measure the impairment loss. That section explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises or reverses an impairment loss.

Module 17 – Property, Plant and Equipment

Compensation for impairment

17.25 An entity shall include in profit or loss compensation from third parties for items of property, plant and equipment that were impaired, lost or given up only when the compensation becomes receivable.

Example – impairment

Ex 29 On 30 September 20X6 a fire destroyed an item of machinery when the carrying amount of the item was CU500,000 (cost CU600,000 less CU100,000 accumulated depreciation). The entity immediately registered a claim of CU700,000 for the replacement cost of the machine with the insurance company. However, the insurance company disputed the claim citing negligence on the part of the entity.

On 15 November 20X6 the fire authorities completed their investigation and informed the insurance company and the entity that an electrical fault caused the fire. As a result of these findings the insurance company notified the entity that its claim for CU700,000 would be settled in full. The insurance company paid the entity CU700,000 on 30 November 20X6.

On 15 December the entity utilised the CU700,000 to acquire a replacement machine, which was immediately installed and ready for use.

How must the entity account for its machinery for the year ended 31 December 20X6?

30 September 20X6

Dr	Profit or loss (impairment of machinery)	CU500,000	
	Cr Accumulated depreciation and accumulated impairment (machinery)		CU500,000

To record impairment of a machine destroyed by fire.

Dr	Accumulated depreciation and accumulated impairment (machinery)	CU600,000	
	Cr Plant (gross carrying amount)		CU600,000

To record the derecognition of a machine destroyed by fire.

15 November 20X6

Dr	Receivable	CU700,000	
	Cr Profit or loss (insurance compensation)		CU700,000

To record the compensation to be received from the insurance company in respect of a machine destroyed by fire.

30 November 20X6

Dr	Cash	CU700,000	
	Cr Receivable		CU700,000

To record receipt of the compensation from the insurance company in respect of a machine destroyed by fire.

Module 17 – Property, Plant and Equipment

15 December 20X6

Dr	Property, plant and equipment (machine, cost)	CU700,000	
	Cr Cash		CU700,000

To record the acquisition of the new machine.

Property, plant and equipment held for sale

17.26 Paragraph 27.9(f) states that a plan to dispose of an asset before the previously expected date is an indicator of impairment that triggers the calculation of the asset’s recoverable amount for the purpose of determining whether the asset is impaired.

Derecognition

17.27 An entity shall derecognise an item of property, plant and equipment:

- (a) on disposal, or
- (b) when no future economic benefits are expected from its use or disposal.

Examples – derecognition

Ex 30 On 14 December 20X5 an entity sold an item of machinery. The purchaser took immediate delivery of the machine.

The entity must derecognise the machine on 14 December 20X5 when the risks and rewards of ownership of the machine passed to the purchaser, assuming all the other conditions in 23.10 are met.

Ex 31 On 1 January 20X5, because of slow sales, an entity temporary halted production at its cardboard box manufacturing plant. Expecting that demand for cardboard boxes would increase in the foreseeable future, the entity did not dispose of its plant.

On 30 June 20X6 management gave up hope that market conditions would improve to the extent that it could restart the manufacture of cardboard boxes. It therefore decided to scrap its cardboard box manufacturing plant. The scrapped plant was physically dumped at the local industrial waste site on 15 July 20X6.

The entity must derecognise the plant on 30 June 20X6. From this date no future economic benefits were expected from its use or disposal.

17.28 An entity shall recognise the gain or loss on the derecognition of an item of property, plant and equipment in profit or loss when the item is derecognised (unless Section 20 *Leases* requires otherwise on a sale and leaseback). The entity shall not classify such gains as revenue.

Module 17 – Property, Plant and Equipment

Examples – when to recognise a gain or loss on derecognition

Ex 32 On 14 December 20X5 an entity sold a machine with a carrying amount of CU20,000 for CU35,000. The purchaser took immediate delivery of the machine.

The entity must derecognise the machine on 14 December 20X5, when the risks and rewards of ownership of the machine passed to the purchaser, assuming all the other conditions in paragraph 23.10 are met (see paragraph 17.29 below). Income (a gain on disposal of equipment) of CU15,000 must be recognised in profit or loss on 14 December 20X5.

Ex 33 On 31 December 20X4 an entity removed its cardboard box manufacturing machine from production when the carrying amount of the machine was CU12,000. However, expecting that demand for cardboard boxes would increase in the foreseeable future the entity did not dispose of its machine. It estimated the recoverable amount of its machine as CU8,000 and that the machine had a remaining useful life of 10 years with a CU5,000 residual value.

In June 20X6 the government of a jurisdiction in which major cardboard manufacturing competitors operate announced significant subsidies designed to protect the profitability of that jurisdiction's cardboard manufacturing industry. Consequently, on 30 June 20X6 management gave up hope that market conditions would improve to the extent that it could restart the manufacture of cardboard boxes. It therefore sold its cardboard box manufacturing machine as scrap for CU5,000 on 1 July 20X6, when its carrying amount was CU7,550.

On 1 July 20X6 (the date of disposal) the entity must recognise in profit or loss the CU2,550 loss on disposal of the machine. The loss (CU2,550) is the amount by which the machine's carrying amount (CU7,550) exceeds the proceeds from its disposal (CU5,000).

Notes:

- On 31 December 20X4 the machine was impaired so its carrying amount was reduced by CU4,000 to CU8,000. The CU4,000 impairment loss was recognised in profit or loss on 31 December 20X4.
- At each subsequent reporting date (ie on 31 December 20X5, assuming the entity does not prepare interim financial reports) the entity would consider whether an impairment test should be performed (see Section 27 *Impairment of Assets*).
- Assuming that there was no further impairment (or reversal thereof) at 31 December 20X5, CU450 depreciation would have been charged to profit or loss from 1 January 20X5 to 30 June 20X6 (ie CU8,000 carrying amount on 1 January 20X5 less CU5,000 residual value = CU3,000 depreciable amount. $CU3,000 \div 10$ years remaining useful life = CU300 depreciation per year. $CU300 \times 18/12$ months = CU450 depreciation for 18 months).

17.29 In determining the date of disposal of an item, an entity shall apply the criteria in Section 23 *Revenue* for recognising revenue from the sale of goods. Section 20 applies to disposal by a sale and leaseback.

Module 17 – Property, Plant and Equipment

Example – date of disposal

Ex 34 On 8 August 20X5 an entity sold an item of machinery, on credit, for CU40,000. The purchaser took immediate delivery of the machine. However, the entity retained legal title of the item until the purchaser settles the purchase price, as security for the payment. The withholding of legal title is not intended to restrict the purchaser's use of the machine. The purchaser paid the entity in full on 8 September and legal title immediately passed to the purchaser.

The entity must derecognise the machine on 8 August 20X5 when the significant risks and rewards of ownership of the machine passed to the purchaser (see paragraph 23.10(a)). The amount is fixed (CU40,000) and it is probable that it will flow to the entity (see paragraph 23.10(c) and (d)). The passive retention of legal title as a means of securing payment does not, in itself, constitute continuing managerial involvement or control (see paragraph 23.10(b)). There are no further costs expected to be incurred in respect of the sale transaction (see paragraph 23.10(e)).

17.30 An entity shall determine the gain or loss arising from the derecognition of an item of property, plant and equipment as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

Example – gain or loss on derecognition

Ex 35 On 1 November 20X5 an entity sold an owner-occupied building with a carrying amount of CU2,000,000 for CU3,500,000. The estate agent retained 10 per cent of the proceeds from the sale as a selling commission. Legal fees in respect of the sale were CU10,000.

On 1 November 20X5 the entity must recognise a gain on the disposal of the building of CU1,140,000 in profit or loss.

Calculation: CU3,500,000 selling price less CU350,000 agent's commission less CU10,000 legal fees = CU3,140,000 net disposal proceeds.

CU3,140,000 net disposal proceeds less CU2,000,000 carrying amount = CU1,140,000 gain on disposal of building.

Disclosures

17.31 An entity shall disclose the following for each class of property, plant and equipment that was deemed appropriate in accordance with paragraph 4.11(a):

- the measurement bases used for determining the gross carrying amount.
- the depreciation methods used.
- the useful lives or the depreciation rates used.
- the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period.
- a reconciliation of the carrying amount at the beginning and end of the reporting period showing separately:

Module 17 – Property, Plant and Equipment

- (i) additions.
- (ii) disposals.
- (iii) acquisitions through **business combinations**.
- (iv) transfers to investment property if a reliable measure of fair value becomes available (see paragraph 16.8).
- (v) impairment losses recognised or reversed in profit or loss in accordance with Section 27.
- (vi) depreciation.
- (vii) other changes.

This reconciliation need not be presented for prior periods.

Notes

In accordance with paragraph 4.11(a), an entity is required to disclose subclassifications of property, plant and equipment in classifications appropriate to the entity. A class of assets is a grouping of assets of a similar nature and use in an entity's operations (see the Glossary). The following are examples of separate classes of property, plant and equipment:

- (a) land;
- (b) land and buildings;
- (c) machinery;
- (d) boats;
- (e) aircraft;
- (f) motor vehicles;
- (g) furniture and fixtures;
- (h) office equipment: and
- (i) investment property whose fair value cannot be measured reliably without undue cost or effort on an ongoing basis.

Example – disclosures

Ex 36 An entity could present the disclosures for each class of property, plant and equipment as follows:

Note 1 Accounting policies

Property, plant and equipment

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Depreciation is charged so as to allocate the cost of assets less their residual values over their estimated useful lives, using the straight-line method. Land has an indefinite useful life and is therefore not

Module 17 – Property, Plant and Equipment

depreciated. The estimated useful lives of other items of property, plant and equipment are:

- Buildings 60 years
- Machinery 10 years
- Office equipment 3 years

Note 4 Property, Plant and Equipment

	<i>Vacant land</i>	<i>Land and buildings</i>	<i>Machinery</i>	<i>Office equipment</i>	<i>Total</i>
	<i>CU'000</i>	<i>CU'000</i>	<i>CU'000</i>	<i>CU'000</i>	<i>CU'000</i>
Cost	1,100	10,000	13,000	4,400	28,500
Accumulated depreciation		(4,133)	(3,200)	(2,300)	(9,633)
Carrying amount at 1 January 20X2	1,100	5,867	9,800	2,100	18,867
Additions			2,000	1,000	3,000
Acquired in a business combination		5,000	4,000	2,000	11,000
Disposals		(1,400) ^(a)	(1,200) ^(c)	(300) ^(e)	(2,900)
Depreciation		(243)	(1,700)	(2,250)	(4,193)
Impairment			(600)		(600)
Exchange difference on translation of a foreign operation	(200)				(200)
Carrying amount at 31 December 20X2	900	9,224	12,300	2,550	24,974
Cost	900	13,000 ^(b)	16,000 ^(d)	6,400 ^(f)	36,300
Accumulated depreciation		(3,776) ^(b)	(3,700) ^(d)	(3,850) ^(f)	(11,326)

Note: these calculations illustrate the workings only and would not comprise part of the actual disclosures in the financial statements.

Calculations (in CU'000)

- (a) CU2,000 cost less CU600 accumulated depreciation.
- (b) CU10,000 + CU5,000 less CU2,000^(a) and CU4,133 + CU243 less CU600^(a)
- (c) CU3,000 cost less CU1,800 accumulated depreciation
- (d) CU13,000 + CU2,000 + CU4,000 less CU3,000^(c) and CU3,200 + CU1,700 + CU600 less CU1,800^(c)
- (e) CU1,000 cost less CU700 accumulated depreciation
- (f) CU4,400 + CU1,000 + CU2,000 less CU1,000^(f) and CU2,300 + CU2,250 - CU700^(e)

Module 17 – Property, Plant and Equipment

17.32 The entity shall also disclose the following:

- (a) the existence and carrying amounts of property, plant and equipment to which the entity has restricted title or that is pledged as security for liabilities.
- (b) the amount of contractual commitments for the acquisition of property, plant and equipment.

Example

Ex 37 An entity could present other disclosures about property, plant and equipment as follows:

Note 3 Profit before tax

The following items have been recognised as expenses (income) in determining profit before tax:

	20X2	20X1
	CU	CU
Insurance proceeds for plant destroyed by flooding	(2,000,000)	-
Impairment of plant	1,000,000	-
Depreciation of property, plant and equipment	4,250,000	4,500,000
Gain on disposal of property, plant and equipment	(50,000)	(400,000)

Note 4 Property, Plant and Equipment

At 31 December 20X2 the entity’s property was pledged as security for a CU100,000 loan from Entity B. This pledge existed at 31 December 20X1.

At 31 December 20X2 the entity had contracted Entity A to construct an office block for the entity. The CU1,000,000 fixed price contract requires construction to begin by 30 June 20X4 and to be completed by 30 June 20X5. The entity had no contractual commitments for the acquisition of property, plant and equipment at 31 December 20X1.

Module 17 – Property, Plant and Equipment

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties.

Classification

Property, plant and equipment are tangible assets that are held for use in the production or supply of goods or services, for administrative purposes, or for rental to others (unless it is classified as an investment property). Furthermore, they are expected to be used during more than one period. In most cases little difficulty is encountered in determining whether a property is an item of property, plant and equipment. However, significant judgement is required to classify some items of property. For example:

- Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.
- In some cases, an entity provides ancillary services, for example security and maintenance services, to the occupants of a property it holds. It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. In most cases security and maintenance services will be insignificant and hence the building would be classified as investment property. However, some companies rent out fully furnished offices including a whole range of services such as information technology systems and administration services (eg many hotels). Such arrangements are in the nature of the provision of a service and the property would be classified as owner-occupied and accounted for under Section 17 *Property, Plant and Equipment*. There are several instances between these extremes where it may be difficult to judge whether the services are insignificant.

Where significant judgement is needed to determine whether a property qualifies as investment property an entity should develop criteria so that it can exercise that judgement consistently in accordance with the definition of investment property.

Module 17 – Property, Plant and Equipment

When the fair value of an investment property can be measured reliably without undue cost or effort on an ongoing basis, after initial recognition an entity measures the investment property at its fair value. Otherwise, investment property is measured after initial recognition using the cost-depreciation-impairment model in Section 17 *Property, Plant and Equipment*. The management of an entity must apply judgement in determining whether the fair value of an investment property can be measured reliably without undue cost or effort on an ongoing basis. Paragraphs 11.27–11.32 of Section 11 *Basic Financial Instruments* provide guidance on determining fair value.

To account for and report property, plant and equipment it is necessary to separate the items into classifications appropriate to the entity (see paragraph 17.31). A class of assets is a grouping of assets of a similar nature and use in an entity's operations (see the Glossary). In most cases little difficulty is encountered in classifying items of property, plant and equipment. However, significant judgement is required to classify some items.

Example

An entity has the following items of property, plant and equipment:

- Property A: A vacant plot of land on which it intends to construct its new administration headquarters;
- Property B: A plot of land that it operates as a landfill site;
- Property C: A plot of land on which its existing administration headquarters are built;
- Property D: A plot of land on which its direct sales office is built;
- Properties E1–E10: Ten separate retail outlets and the land on which they are built;
- Equipment A: Computer systems at its headquarters and direct sales office that are integrated with the point of sale computer systems in the retail outlets;
- Equipment B: Point of sale computer systems in each of its retail outlets;
- Furniture and fittings in its administrative headquarters and its sales office;
- Shop fixtures and fittings in its retail outlets.

The entity's only investment property is Property F—a vacant plot of land held for capital appreciation. The fair value of the plot of land cannot be measured reliably without undue cost or effort on an ongoing basis.

How many classes of property, plant and equipment must the entity disclose?

To answer this question one must apply judgement.

A class of assets is defined as a grouping of assets of a similar nature and use in an entity's operations.

The nature of land without a building is different to the nature of land on which a building has been erected.

Consequently land without a building is a separate class of asset from land and buildings. Furthermore, the nature and use of land that is operated as a landfill site is different from vacant land. Although the nature of Property A and Property F are probably the same, the use of the land is sufficiently different for the investment property to be disclosed as a separate class of property, plant and equipment. Judgement must be applied to determine if the entity's retail outlets are sufficiently different in nature and use from office buildings to be treated as a separate class of land and buildings.

Module 17 – Property, Plant and Equipment

The computer equipment is integrated across the organisation and would probably be classified as a single separate class of asset.

Furniture and fittings used for administrative purposes could be sufficiently different to shop fixtures and fittings in retail outlets to be classified in two separate classes of assets.

Measurement

An entity shall measure property, plant and equipment at its cost at initial recognition.

Significant judgements in measuring the cost of an item of property, plant and equipment at initial recognition include:

- If payment for the item is deferred beyond normal credit terms—determining the discount rate at which to discount all future payments to arrive at the present value that will be included in the cost of the property.
- If the item is acquired in an exchange for a non-monetary asset—estimating the fair value of the non-monetary asset.
- If applicable—estimating the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs when the item is acquired.

After initial recognition an entity must measure all items of property, plant and equipment at cost less any accumulated depreciation and any accumulated impairment losses. Significant judgements in accounting for the depreciation of property, plant and equipment may include:

- allocating the amount initially recognised in respect of an item of property, plant and equipment to its major components that, in accordance with paragraph 17.16, are required to be depreciated separately;
- estimating the useful life of the item (or significant part of the item) of property, plant and equipment;
- estimating the residual value of the property, plant and equipment (or significant part of the item); and
- determining the appropriate depreciation method that reflects the pattern in which the entity expects to consume the property, plant and equipment (or significant part of the item).

Significant judgements in accounting for the impairment of property, plant and equipment may include:

- assessing whether there is any indication that an item of property, plant and equipment may be impaired; and
- if there is an indication that the property, plant and equipment may be impaired—determining the recoverable amount of the property, plant and equipment.

Module 17 – Property, Plant and Equipment

COMPARISON WITH FULL IFRSs

A high level overview of differences between the requirements at 9 July 2009 of accounting and reporting property, plant and equipment in accordance with full IFRSs (see IAS 16 *Property, Plant and Equipment*) and the *IFRS for SMEs* (see Section 17 *Property, Plant and Equipment*) includes:

- The *IFRS for SMEs* is drafted in simple language and includes significantly less guidance on how to apply the principles.
- Full IFRSs permit an option to use the revaluation model for the measurement of property, plant and equipment after initial recognition. The *IFRS for SMEs* does not.
- Full IFRSs require an annual review of residual value, useful life and depreciation method of property, plant and equipment. The *IFRS for SMEs* requires a review *only* if there is an indication that there has been a significant change since the last annual reporting date.
- For differences related to impairment testing see Module 27 *Impairment of Assets*.

Module 17 – Property, Plant and Equipment

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting property, plant and equipment in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

Property, plant and equipment are defined as:

- (a) tangible assets held for sale in the ordinary course of business.
- (b) tangible assets held to earn rentals or for capital appreciation or both.
- (c) tangible assets held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and expected to be used during more than one reporting period.

Question 2

An entity operates a bed and breakfast from a building it owns. The entity also provides its guests with other services including housekeeping, satellite television and broadband internet access. The daily room rental is inclusive of these services. Furthermore, upon request, the entity conducts tours of the surrounding area for its guests. Tour services are charged for separately.

The entity should account for the building as:

- (a) property, plant and equipment
- (b) investment property
- (c) inventory

Question 3

An entity must measure its property, plant and equipment after initial recognition at:

- (a) cost.
- (b) cost less any accumulated depreciation less any accumulated impairment losses.
- (c) cost less any accumulated depreciation less any accumulated impairment losses plus the cost of day-to-day servicing.
- (d) cost plus the cost of day-to-day servicing.

Module 17 – Property, Plant and Equipment

Question 4

An entity operates an executive aviation service. The entity's only item of property, plant and equipment is an aircraft that it acquired for CU10,400,000. The cost of the aircraft is attributed to its significant parts as follows: the jet engine (60%), body (20%) and aviation equipment (10%) and furniture and fittings (10%).

A condition of operating an aircraft is that it is inspected by the aviation authorities every three years. An inspection costs CU400,000. The jet had been inspected at the manufacturer's expense before delivery to the entity.

Aviation regulations require the jet engine to be replaced when it has flown 2,000,000 air miles. Management intends fitting a new engine to the aircraft when it requires replacement so that the aircraft can be used for approximately 10 years, at which time it intends to scrap the aircraft.

Management does not expect to replace the body of the aircraft or the aviation equipment. However, management assesses the useful life of the furniture and fittings as five years at which time they will be scrapped and replaced.

What is the cost of each of the significant parts of the aircraft that the entity must depreciate separately:

- (a) CU6,240,000 jet engine, CU2,080,000 body, CU1,040,000 aviation equipment and CU1,040,000 furniture and fittings.
- (b) CU10,400,000 jet aircraft.
- (c) CU6,000,000 jet engine, CU3,000,000 body and equipment, CU1,000,000 furniture and fittings and CU400,000 aviation inspection.

Question 5

Facts are the same as in Question 4.

What depreciation methods are most appropriate for the entity to apply to compute depreciation for the significant parts of the aircraft:

- (a) straight-line method for all parts of the aircraft.
- (b) units of production method, based on air miles flown, for the jet engines and the straight-line method for all other parts of the aircraft.
- (c) units of production method, based on air miles flown, for all parts of the aircraft.
- (d) diminishing balance method for all parts of the aircraft.

Module 17 – Property, Plant and Equipment

Question 6

A building is held by a subsidiary to earn rentals under an operating lease from its parent. The parent manufactures its products in the rented building. The fair value of the building can be measured reliably without undue cost or effort on an ongoing basis.

The building is:

- (a) accounted for as an investment property by the subsidiary and an investment property by the group.
- (b) accounted for as property, plant and equipment by both the subsidiary and the group.
- (c) accounted for as investment property by both the subsidiary and the group.
- (d) accounted for as an investment property by the subsidiary and as an item of property, plant and equipment by the group.

Question 7

On 1 January 20X1 an entity acquired a building for CU95,000, including CU5,000 non-refundable purchase taxes. The purchase agreement provided for payment (including payment of the purchase taxes) to be made in full on 31 December 20X1. Legal fees of CU2,000 were incurred in acquiring the building and paid on 1 January 20X1.

The building is occupied by the entity's administrative staff.

An appropriate discount rate is 10 per cent per year.

The entity should measure the initial cost of the building at:

- (a) CU102,000
- (b) CU97,000
- (c) CU88,364
- (d) CU107,000.

Question 8

On 1 January 20X1 an entity acquired a building for CU100,000. At 31 December 20X1 management:

- assessed the building's useful life as 40 years from the date of acquisition
- assessed the building's residual value as CU20,000
- assessed the entity will consume the building's future economic benefits evenly over 40 years from the date of acquisition
- assessed the fair value of the building at CU130,000.

The building is occupied by the entity's sales staff.

The entity should measure the carrying amount of the building on 31 December 20X1 at:

- (a) CU100,000
- (b) CU98,000
- (c) CU130,000
- (d) CU127,250

Module 17 – Property, Plant and Equipment

Question 9

On 31 December 20X2 the entity reassessed the property described in Question 8 as follows:

- the building's useful life as 60 years from the date of acquisition
- the building's residual value as CU10,000
- the entity will consume the building's future economic benefits evenly over 60 years from the date of acquisition
- the fair value of the building at CU160,000.

The entity should measure the carrying amount of the building on 31 December 20X2 at:

- (a) CU96,508
- (b) CU96,000
- (c) CU160,000
- (d) CU125,263

Question 10

On 1 January 20X1 an entity acquired a tract of land for an undetermined purpose.

On 1 January 20X4 the entity began to construct a building on the land for use as its administrative headquarters. On 1 January 20X8 the entity's administrative staff moved out of the building and into newly acquired premises. The building was immediately rented to an independent third party under an operating lease. On 31 December 20X9 the entity accepted an unsolicited offer from the tenant to purchase the building from the entity with immediate effect.

The fair value of the building can be determined reliably without undue cost or effort on an ongoing basis.

The entity should account for the building as:

- (a) investment property from the date of acquisition (1 January 20X1) to the date of disposal (31 December 20X9).
- (b) investment property during 20X1–20X3 and as property, plant and equipment during 20X4–20X9.
- (c) investment property during 20X1–20X3 and 20X8–20X9 and as property, plant and equipment during 20X4–20X7.
- (d) property, plant and equipment during 20X1–20X7 and as investment property during 20X8–20X9.

Module 17 – Property, Plant and Equipment

Answers

- Q1 (c) see paragraph 17.2.
- Q2 (a) reason—forms part of an active business with integrated cash flows, rather than a passive investment (see paragraphs 16.2(a) and 17.2(a)).
- Q3 (b) see paragraph 17.15
- Q4 (c) see paragraphs 17.7 and 17.16.
calculation—cost excluding the cost of the inspection performed prior to delivery = CU10,000,000. Allocation 60% jet engine, 30% body and equipment and 10% furniture and fittings.
- Q5 (b) see paragraph 17.22
- Q6 (d) see paragraphs 9.2 and 16.2
- Q7 (c) calculation—(CU95,000 purchase price excluding refundable taxes) ÷ 1.1 = CU86,364
present value of the purchase price + CU2,000 direct costs (legal fees) = CU88,364
- Q8 (b) calculation—CU100,000 cost less (CU80,000 depreciable amount ÷ 40 years' useful life × 1 year in use) accumulated depreciation = CU98,000
- Q9 (a) calculation—CU100,000 cost less [CU2,000 accumulated depreciation at the beginning of the reporting period + (CU88,000 remaining depreciable amount ÷ 59 years' remaining useful life × 1 year in use since the beginning of the current reporting period) = CU3,492 accumulated depreciation] = CU96,508
- Q10 (c) see paragraphs 16.2, 16.9 and 17.2

Module 17 – Property, Plant and Equipment

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting property, plant and equipment in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answer against that set out below this test.

Case study 1

SME A incurred (and paid) the following expenditures in acquiring an administration building and the land on which it is built:

<i>Date</i>	<i>CU</i>	<i>Additional information</i>
1 January 20X1	200,000,000	20 per cent of the price is attributable to the land
1 January 20X1	20,000,000	Non-refundable transfer taxes (not included in the CU200,000,000 purchase price)
1 January 20X1	1,000,000	Legal costs directly attributable to the acquisition
1 January 20X1	10,000	Reimbursing the previous owner for prepaying the non-refundable local government property taxes for the six-month period ending 30 June 20X1
30 June 20X1	20,000	Non-refundable annual local government property taxes for the year ending 30 June 20X2
Throughout 20X1	120,000	Day-to-day repairs and maintenance, including the salary and other costs of the administration and maintenance staff. These costs are attributable equally to each of the 10 units.

At 31 December 20X1 SME A made the following assessments:

- Useful life of the building: 50 years from the date of acquisition
- Residual value of the building: CU20,000,000
- The entity will consume the building’s future economic benefits evenly over 50 years from the date of acquisition
- Fair value less costs to sell of the land and building: CU250,000,000.

Prepare accounting entries to record the effects of the property, plant and equipment in the accounting records of SME A for the year ended 31 December 20X1.

Module 17 – Property, Plant and Equipment

Answer to case study 1

At 1 January 20X1

Dr	Land and buildings (cost)	CU200,000,000 ^A	
	Cr Cash		CU200,000,000

To recognise the acquisition of the property.

Dr	Land and buildings (cost)	CU20,000,000 ^A	
	Cr Cash		CU20,000,000

To recognise the non-refundable transfer taxes incurred in acquiring the property.

Dr	Land and buildings (cost)	CU1,000,000 ^A	
	Cr Cash		CU1,000,000

To recognise legal costs directly attributable to the acquisition of the property.

Dr	Prepaid expenses (asset)	CU10,000	
	Cr Cash		CU10,000

To recognise local government property taxes prepaid for the six months ending 30 June 20X1.

At 30 June 20X1

Dr	Prepaid expenses (asset)	CU20,000	
	Cr Cash		CU20,000

To recognise local government property taxes paid on 30 June 20X1 for the twelve months ending 30 June 20X2.

For the year ended 31 December 20X1

Dr	Profit or loss (operating expenses)	CU10,000	
	Cr Prepaid expenses (asset)		CU10,000

To recognise as an expense local government property taxes prepaid on 1 January 20X1 for the first six months ending 30 June 20X1.

Dr	Profit or loss (operating expenses)	CU10,000	
	Cr Prepaid expenses (asset)		CU10,000

To recognise local government property taxes paid on 30 June 20X1 for the last six months of the current reporting period. CU10,000 will remain as an asset as it relates to the first six months of the next reporting period.

Dr	Profit or loss (operating expenses)	CU120,000	
	Cr Cash		CU120,000

To recognise day-to-day repairs and maintenance of the building during 20X1.

Module 17 – Property, Plant and Equipment

Dr	Profit or loss (operating expenses)	CU3,136,000 ^(a)	
	Cr Accumulated depreciation (PPE—buildings)		CU3,136,000

To recognise depreciation of buildings during 20X1.

The calculations and explanatory notes below do not form part of the answer to this case study:

- (a) $80\% \times \text{CU}221,000,000^{(b)} = \text{CU}176,800,000$ cost of buildings. $[\text{CU}176,800,000 \text{ cost less CU}20,000,000 \text{ residual value}] \div 50 \text{ years (consume future economic benefits evenly over the 50-year useful life of the building)} = \text{CU}3,136,000$ depreciation for the year
- (b) $\Sigma^A = \text{CU}221,000,000$ cost of land and buildings

Module 17 – Property, Plant and Equipment

Case study 2

SME B has one item of property, plant and equipment—the office building occupied by its administrative staff and the land on which it is built. At 31 December 20X1 the carrying amount of the property was CU2,000,000, net of CU1,000,000 accumulated depreciation. SME B depreciates the building on the straight-line method over 50 years to a nil residual value. The land on which the building is situated is immaterial.

On 30 June 20X2 SME B acquired all of the equity of SME C. Information about SME C's property, plant and equipment on 30 June 20X2 is summarised in the table below.

<i>Description</i>	<i>Remaining useful life</i>	<i>Carrying amount (CU)</i>	<i>Residual value (CU)</i>	<i>Fair value (CU)</i>
Factory building A	10 years	1,000,000	100,000	1,500,000
Factory building B	15 years	6,000,000	1,500,000	9,000,000
Office building A	20 years	4,500,000	2,500,000	7,000,000
Land A (vacant)	Indefinite	300,000	4,000,000	4,000,000
Land B (vacant)	Indefinite	6,000	1,000,000	1,000,000
Land C (vacant)	Indefinite	9,000	2,000,000	2,000,000
Total		11,815,000		24,500,000

On 30 September 20X2 in response to an unsolicited offer, SME C disposed of Factory building B for CU9,100,000.

On 1 October 20X2 SME C subdivided Land B into 30 plots and began to develop residential units on each of the plots, with a view to selling the residential units and the land on which they are built in the ordinary course of business.

On 12 October 20X2 SME C was granted planning permission, at a cost of CU500,000, for the development of an office block on Land C. SME C intends to use the office block for the sales staff of its mail order operations.

On 1 November 20X2 SME C commenced the operation of a landfill site on Land A. The cost of converting Land A to a landfill site was CU100,000. The landfill site is expected to operate for 10 years before it will be full. Once full, SME C intends to abandon the site.

On 16 December 20X2 SME C contracted Entity D (an independent third party) to construct the office block on Land C. The CU10,000,000 fixed price contract provides for construction to begin by 30 June 20X3 and be completed by 30 June 20X5.

On 31 December 20X2 SME B's land and building was pledged as security for a CU3,000,000 loan from Bank A. The loan was advanced to SME B on 30 December 20X2 and bears interest at the fixed rate of 3 per cent per year. The loan is repayable in full on 31 December 20X8.

Module 17 – Property, Plant and Equipment

At 31 December 20X2 SME B group assessment confirmed the useful lives, residual values and depreciation method applied for all property, plant and equipment. Furthermore, the impairment indicator review found no indication that any item of property, plant and equipment was impaired.

The land on which buildings are situated is immaterial.

Draft an extract showing how property, plant and equipment could be presented and disclosed in the consolidated financial statements of SME B group for the year ended 31 December 20X2.

Module 17 – Property, Plant and Equipment

Answer to case study 2

Extract from SME B group consolidated statement of financial position at 31 December 20X2:

Description	Note	20X2	20X1
Property, plant and equipment	14	CU16,789,167	CU2,000,000

Extract from SME B group consolidated statement of financial position at 31 December 20X2:

Note 1 Accounting policies

Property, Plant and Equipment

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

Depreciation is charged so as to allocate the cost of assets less their residual values over their estimated useful lives, using the straight-line method. Land, except landfill sites, have an indefinite useful life and are therefore not depreciated. The useful life of buildings is 50 years from the date of construction. The useful life of landfill sites is 10 years from the date of excavation.

Note 3 Profit before tax

The following items have been recognised as expenses (income) in determining profit before tax:

	20X2	20X1
	CU	CU
Profit on disposal of property, plant and equipment	(225,000) (a)	–
Depreciation	435,833 (o)+(i)	60,000 (b)

Note 14 Property, plant and equipment

Description	Landfill site (CU)	Vacant land (CU)	Land and buildings (CU)	Total (CU)
Cost			3,000,000	3,000,000
Accumulated depreciation			(1,000,000)	(1,000,000)
Carrying amount at 31 December 20X1			2,000,000	2,000,000
Additions	100,000	500,000 (c)		600,000
Acquired in a business combination		7,000,000 (d)	17,500,000 (e)	24,500,000
Transferred to inventory		(1,000,000) (f)		(1,000,000)
Reallocated for change in use	4,000,000	(4,000,000)		

Module 17 – Property, Plant and Equipment

Disposals			(8,875,000)	^(g)	(8,875,000)
Depreciation	(68,333)	^(o)	(367,500)	⁽ⁱ⁾	(435,833)
Carrying amount					
at 31 December 20X2	4,031,667	2,500,000	10,257,500		16,789,167
Cost	4,100,000	2,500,000	^(l) 11,500,000	^(m)	18,100,000
Accumulated depreciation	(68,333)	^(o)	(1,242,500)	⁽ⁿ⁾	(1,310,833)

On 31 December 20X2 the group had contracted with Entity D to construct an office block on vacant land owned by the group. The CU10,000,000 fixed price contract requires construction to begin by 30 June 20X3 and to be completed by 30 June 20X5. There were no contractual commitments at 31 December 20X1.

At 31 December 20X2 SME B's property was pledged as security for a CU3,000,000 loan from Bank A. The loan bears interest at the fixed rate of 3 per cent per year and is repayable in full on 31 December 20X8. The group's property was unencumbered at 31 December 20X1.

The calculations and explanatory notes below do not form part of the answer to this case study:

- (a) CU9,100,000 proceeds from the sale of Factory building B less CU8,875,000^(g) carrying amount = CU225,000 gain on disposal of Factory Building B.
- (b) CU3,000,000 cost ÷ 50 years = CU60,000 depreciation per year.
- (c) CU500,000 cost of planning permission for Land C (see paragraphs 16.7 and 17.10(b)).
- (d) CU4,000,000 Land A + CU1,000,000 Land B + CU2,000,000 Land C = CU7,000,000 (ie cost to the group is fair value at the date of acquisition) (see paragraph 19.14)
- (e) CU1,500,000 Factory building A + CU9,000,000 Factory building B + CU7,000,000 Office building A (ie cost to the group is fair value at the date of acquisition). Refer to *IFRS for SMEs*, paragraph 19.14 = CU17,500,000 buildings.
- (f) CU1,000,000 carrying amount of Land B now used for the sale in the ordinary course of business (ie inventory). Refer to *IFRS for SMEs*, paragraph 13.1(a)
- (g) CU9,000,000 cost less CU125,000 accumulated depreciation^(h) = CU8,875,000 carrying amount of Factory building B at the date of its disposal.
- (h) (CU9,000,000 cost less CU1,500,000 residual value) ÷ 15 years × 3/12 months = CU125,000 accumulated depreciation on Factory building B at the date of its disposal (from 30 June to 30 September 20X2)
- (i) CU60,000 SME B's property^(b) + CU70,000 Factory building A^(j) + CU125,000 Factory building B^(h) + CU112,500 Office building A^(k) = CU367,500.
- (j) (CU1,500,000 cost less CU100,000 residual value) depreciable amount ÷ 10 years' useful life × 6/12 months = CU70,000.
- (k) (CU7,000,000 cost less CU2,500,000 residual value) depreciable amount ÷ 20 years' useful life × 6/12 months = CU112,500.
- (l) CU2,500,000 Land C.
- (m) CU3,000,000 SME B's property + CU1,500,000 Factory building A + CU7,000,000 Office building A = CU11,500,000 buildings.
- (n) CU1,060,000 SME B's property + CU70,000 Factory building A^(j) + CU112,500 Office building A^(k) = CU1,242,500.
- (o) (CU4,100,000 cost less nil residual value (abandoned)) depreciable amount ÷ 10 years' useful life × 2/12 months = CU68,333.