

Staff Issues Paper: Forming Preliminary Board Views on IASB ED/2012/5 *Clarification of Acceptable Methods of Depreciation and Amortisation*

Introduction to Primary Issue

- 1 IASB ED/2012/5 *Clarification of Acceptable Methods of Depreciation and Amortisation* (which is incorporated in AASB ED 231 of the same title) sets out the IASB's proposal "to amend IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* to prohibit a depreciation or amortisation method that uses revenue generated from an activity that includes the use of an asset" (ED, Question 1) – hereafter, "a revenue-based depreciation or amortisation method"¹.
- 2 The IASB's reason for this proposal is that a revenue-based depreciation or amortisation method "reflects a pattern of future economic benefits being generated from the asset, rather than reflecting the expected pattern of consumption of the future economic benefits embodied in the asset" (ED, Question 1).
- 3 This staff paper analyses that IASB proposal, identifies what AASB staff see as the significant issues arising from the IASB ED, and sets out the AASB staff's preliminary recommendations on those issues. The purpose of this paper is to assist the Board in forming preliminary views on the significant issues arising from the IASB ED – these preliminary views would be subject to amendment in light of further comment letters received on the ED (to date, two comment letters have been received: see Agenda Paper 13.4).

Summary of AASB Staff's Preliminary Views

AASB Staff's Reasoning, and Preliminary Recommendations, on the Primary Issue

- 4 AASB staff think it is generally inappropriate to apply a revenue-based depreciation or amortisation method. However, we think that, in some circumstances, a revenue-based depreciation or amortisation method might (and probably would) be appropriate (see paragraph 18 for a description of those circumstances). Therefore, AASB staff do not support the IASB's proposal to prohibit, in all cases², applying a revenue-based depreciation or amortisation method.
- 5 AASB staff suggest that, if the Board agrees with their preliminary views in paragraph 4 above, the main options for the Board would be recommend to the IASB that it either:
 - (a) requires the application of a revenue-based depreciation or amortisation method when and only when specified circumstances arise; or
 - (b) does not proceed further with the above-described proposed primary amendment to IAS 16 and IAS 38. This is the AASB staff's preference, because various factors mentioned in paragraph 56 of IAS 16 and paragraph 90

¹ This phrase is used in paragraph BC1 of the IASB's Basis for Conclusions on IASB ED/2012/5.

² AASB staff acknowledge that the IASB ED would permit a revenue-based depreciation or amortisation method as a proxy for applying another depreciation or amortisation method (see paragraphs 12 and 22 – 24 below). However, AASB staff observe that the IASB ED does not treat this as an exception to its proposed principle that a revenue-based depreciation or amortisation method would be prohibited.

of IAS 38 can affect the selection of an appropriate depreciation or amortisation method, and judgement would be required to determine the most appropriate method (see paragraph 20 below).

Question for Board members

- Q1 Do you tentatively agree (subject to considering any future comment letters on AASB ED 231) with the AASB staff's preliminary recommendation that the Board's submission on IASB ED/2012/5 should:
- (a) not support the IASB's proposal to prohibit, in all cases, applying a revenue-based depreciation or amortisation method; and
 - (b) encourage the IASB not to proceed further with its proposed amendment to IAS 16 and IAS 38?

AASB Staff's Preliminary Recommendations on Other Significant Issues

- 6 AASB staff's other preliminary recommendations are:
- (a) if the IASB implements its primary proposal described in paragraph 1 above:
 - (i) it should clarify the relationship between the prohibition of a revenue-based depreciation or amortisation method and the related discussion in the Basis for Conclusions (see paragraphs 22 – 24 below);
 - (ii) it should expand its description of a revenue-based depreciation or amortisation method to include reference to taking into account expected changes in the market demand for outputs from an asset (see paragraphs 28 – 30 below); and
 - (iii) the proposed transitional provisions in the ED would be appropriate (see paragraphs 31 – 33 below); and
 - (b) if the IASB were not to implement its primary proposal described in paragraph 1 above, it should not add proposed new paragraphs 62B of IAS 16 and 98B of IAS 38 (see paragraphs 25 – 27 below).

Question for Board members

- Q2 Do you tentatively agree with the other preliminary recommendations in paragraph 6?

Discussion of Issues regarding Questions in the ED

Background

Present requirements of IAS 16 and IAS 38

- 7 Under the related definitions of 'depreciation' and 'depreciable amount' in IAS 16, depreciation of property, plant and equipment is the systematic allocation of the cost of an asset (or other amount substituted for cost), less its residual value, over the

asset's useful life (IAS 16, paragraph 6). Under IAS 38 (paragraph 8), amortisation has the same meaning for intangible assets.

- 8 Paragraph 60 of IAS 16 and paragraph 97 of IAS 38 specify that the depreciation or amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- 9 The appropriateness of particular methods of depreciation or amortisation depends on the meaning of 'future economic benefits'. This is discussed in paragraphs 14 – 15 below, in light of paragraph 10 below.
- 10 Paragraph 56 of IAS 16 states that: "The future economic benefits embodied in an asset are consumed by an entity principally through its use."³ Paragraph 56 of IAS 16 and paragraph 90 of IAS 38 identify factors to consider in determining an asset's useful life (AASB staff think, by implication, these factors should also be considered in determining an asset's depreciation or amortisation method). Some of these factors are not directly related to revenue expected to be generated by the asset (e.g., for an item of property, plant and equipment, they include change in capacity, physical output, and wear and tear). However, under IAS 16 and IAS 38, one of those factors is directly related to revenue expected to be generated by the asset—namely, commercial obsolescence arising from a change in the market demand for the asset's output.⁴

Elaboration of IASB's primary proposal

- 11 The ED's proposed new paragraphs 62A of IAS 16 and 98A of IAS 38 say, with IAS 38-specific words in parentheses:

"A method that uses revenue generated from an activity that includes the use of an asset (intangible asset) is not an appropriate depreciation (amortisation) method for that asset (intangible asset) ..."
- 12 Paragraphs BC3 – BC5 of the IASB's Basis for Conclusions on its ED seem to indicate that:
 - (a) in limited circumstances, "revenue could be used to reflect the pattern in which the future economic benefits of the asset are expected to be consumed", namely, "when the use of a revenue-based method gives the same result as the use of a units of production method" (paragraph BC3); and
 - (b) examples of circumstances referred to in (a) immediately above are some types of intellectual property assets, the value of which declines at a faster rate at first and a slower rate thereafter. For example, paragraphs BC4 – BC5 of the Basis for Conclusions say that, for acquired rights to broadcast a film, "the number of viewers attracted could be used as a reasonable basis for the pattern in which the benefits for those rights are expected to be consumed", and that advertising revenue might serve as an equivalent for viewer numbers.

³ IAS 38 does not include this comment.

⁴ IAS 16, paragraph 56(c); IAS 38, paragraph 90(c) refers simply to 'commercial obsolescence'.

- 13 The ED's proposed new paragraphs 62B of IAS 16 and 98B of IAS 38 say information about technical or commercial obsolescence of an output (e.g., an expected future reduction in the unit selling price of an output of the asset) is relevant for estimating the estimated pattern of consumption of an asset's future economic benefits, when applying the diminishing balance method of depreciation or amortisation.

AASB Staff Analysis

Broad meaning of 'future economic benefits'

- 14 Paragraph 10 above notes the AASB staff's view that some of the factors that IAS 16 and IAS 38 require to be considered in determining an asset's depreciation or amortisation method are directly related to revenue expected to be generated by the asset, whilst other factors are not. AASB staff think this indicates that the meaning of 'future economic benefits' implicit in IAS 16 and IAS 38 encompasses input values (e.g., historical cost) and output values (i.e., amounts reflecting expected future revenues). This is consistent with the general requirement under IFRSs to measure non-financial assets at the lower of cost (or revalued amount) and recoverable amount.
- 15 Because of this broad meaning of 'future economic benefits' that AASB staff think is implicit in IAS 16 and IAS 38, AASB staff think it is difficult and potentially inappropriate to be prescriptive about whether (and when) to use a revenue-based depreciation or amortisation method. This key AASB staff view underlies the discussion in paragraphs 16 – 21 below.

When a revenue-based depreciation or amortisation method would seem inappropriate

- 16 When commercial obsolescence arising from a change in the market demand for the asset's output is not a significant factor affecting an asset's carrying amount (e.g., recoverable amount) or estimated useful life, AASB staff think it would generally be inappropriate to apply a revenue-based depreciation or amortisation method. This is because AASB staff:
- (a) think consumptions of depreciable or amortisable assets held to generate revenue do not necessarily generate revenue, even though they are incurred with the aim of generating revenue. Revenue arises from selling and delivering outputs, and consumptions of assets can occur without generating sales. Therefore, it would be inappropriate to assume a linear relationship between depreciation/amortisation and revenue, and thus recognise depreciation/amortisation for a period according to the percentage of total expected revenues from the asset that were recognised during the period, unless commercial obsolescence were a significant factor affecting the asset's carrying amount or estimated useful life (see the discussion of commercial obsolescence in paragraphs 18 – 19 below);
 - (b) generally agree with the argument in paragraph BC2 of the IASB's Basis for Conclusions on the ED that "a revenue-based depreciation or amortisation method should not be applied because it reflects a pattern of economic benefits being generated from operating the business (of which the asset is part) rather than the economic benefits being consumed through the use of the asset";

- (c) observe that, even if the principle-based argument in paragraph 16(b) above were not accepted, in practical terms it is often very difficult to reasonably attribute revenue to specific assets because revenue is generated jointly by various assets. Therefore, it would often not be possible to reasonably apply a revenue-based depreciation or amortisation method. For the sake of consistency, applying a revenue-based depreciation or amortisation method should be used as infrequently as possible, i.e., only when commercial obsolescence arising from a change in the market demand for the asset's output is a significant factor affecting an asset's carrying amount or estimated useful life and the future revenues arising from the asset can reasonably be estimated;
- (d) think that, in relation to paragraph 16(a) above, various expenses other than depreciation or amortisation of assets (e.g., employee benefits expenses not capitalised into assets, and borrowing costs) are incurred with the aim of generating revenue. Assuming a linear relationship between depreciation/amortisation and revenue, and thus basing depreciation/amortisation on revenues, seems logically inconsistent with recognising employee benefits expenses, borrowing costs and other expenses independently of revenues; and
- (e) observe that depreciable or amortisable assets are generally not measured at an amount representing the revenues they are expected to generate for the entity that holds them. They are measured at cost or an amount substituted for cost (fair value less any subsequent accumulated depreciation/amortisation and subsequent accumulated impairment losses). Even when assets are revalued, their fair value is often measured on a basis other than future revenues (e.g., the cost approach is often applied). When the future economic benefits embodied in assets are measured on a different basis than the revenues that the assets are expected to generate⁵, it would seem inconsistent to measure the *consumption* of future economic benefits embodied in those assets on the basis of associated revenues (however, see paragraph 18(a) for circumstances in which future economic benefits embodied in assets are measured on a basis that reflects future expected revenues).

17 In the past, some practitioners have debated whether it is appropriate to apply a revenue-based depreciation or amortisation method to particular types of assets, with depreciation or amortisation charges increasing over the asset's estimated useful life on the basis that revenue is expected to increase over time (because of projected increases in prices, market size and/or market share). If commercial obsolescence arising from a change in the market demand for the asset's output is not a significant factor affecting the carrying amount or useful lives of such assets, AASB staff think applying a revenue-based depreciation or amortisation method to those assets might understate depreciation or amortisation in the earlier years of those assets' useful lives. This is because the pattern of depreciation or amortisation might be inconsistent with the main factors causing the assets' depreciation or amortisation, e.g., usage and wear and tear.

⁵ In these circumstances, AASB staff assume the pattern of revenues would therefore not be an appropriate proxy for the consumption of the future economic benefits embodied in the assets.

When a revenue-based depreciation or amortisation method might be appropriate

- 18 AASB staff think, in principle⁶, it might (and probably would) be appropriate to apply a revenue-based depreciation or amortisation method when and only when:
- (a) the asset's future economic benefits are measured on a basis that reflects future expected revenues. This can happen when:
 - (i) the asset has been revalued and its fair value is measured using an 'income approach' as described in paragraphs B10 – B30 of IFRS 13 *Fair Value Measurement*; or
 - (ii) the asset is measured at its recoverable amount as a result of recognising an impairment loss (e.g., it is measured at its value in use);or
 - (b) commercial obsolescence arising from a change in the market demand for the asset's output is a significant factor affecting an asset's estimated useful life and the future revenues arising from the asset can reasonably be estimated.
- 19 In the circumstances referred to in paragraph 18(b), AASB staff think the consumption of future economic benefits will be significantly (or even primarily) composed of a reduction in the asset's revenue-generating ability. An example is an acquired right to broadcast a film, in respect of which paragraphs BC4 – BC5 of the Basis for Conclusions on the ED say "the number of viewers attracted could be used as a reasonable basis for the pattern in which the benefits for those rights are expected to be consumed" (see paragraph 12(b) above). Within the period of that right, the capacity of the right to continue to be exercised might not change significantly and the film might not be subject to significant wear and tear or technical obsolescence. However, the value of the right may decline at a faster rate at first and a slower rate thereafter. Therefore, if the entity did not apply a revenue-based amortisation method, e.g., it applied a straight-line method, it would seem likely that an impairment loss would need to be recognised in respect of the asset. AASB staff think it would be inappropriate to rely on the recognition of impairment losses because the amortisation method applied leaves the asset overstated, when those 'impairment losses' were reasonably foreseeable when the assets were acquired. A similar issue arises in respect of other types of intellectual property assets, such as licences, with a finite useful life.

Whether to recommend requiring the application of a revenue-based depreciation or amortisation method when and only when specified circumstances arise

- 20 Although AASB staff think it might be appropriate to apply a revenue-based depreciation or amortisation method in the circumstances described in paragraph 18 above, we do not suggest recommending that the IASB requires the application of such a method when and only when those specific circumstances arise. This is because various factors mentioned in paragraph 56 of IAS 16 and paragraph 90 of IAS 38 can affect the selection of an appropriate depreciation or amortisation method,

⁶ However, see the discussion of the practical difficulties with stipulating the circumstances in which such a method should be applied, in paragraph 20 below.

and judgement would be required to determine the most appropriate method. For example, an entity's management might conclude that commercial obsolescence arising from a change in the market demand for the asset's output is a significant factor affecting the pattern of depreciation or amortisation of a particular asset, but that other factors (such as wear and tear) are more significant. The view in this paragraph reflects the AASB staff's preliminary view (expressed in paragraph 14 above) that a broad meaning of 'future economic benefits' is implicit in IAS 16 and IAS 38.

- 21 For the reason in paragraph 20 above, AASB staff suggest that if the Board agrees with our preliminary view not to support the IASB's proposal to prohibit, in all cases, applying a revenue-based depreciation or amortisation method, the Board should recommend that the IASB does not proceed further with the ED.

Related issues

Ambiguity of IASB's proposals

- 22 As noted in paragraphs 11 – 12 above, proposed paragraphs 62A of IAS 16 and 98A of IAS 38 would prohibit applying a revenue-based depreciation or amortisation method, whilst the Basis for Conclusions clarifies that such a method may be used when it gives the same result as the units of production method (in other words, such a method may be used as a proxy for an acceptable depreciation or amortisation method).
- 23 AASB staff think the IASB's proposals on this issue are potentially ambiguous. This is because, in relation to the example in paragraphs BC4 – BC5 of the Basis for Conclusions, it is not clear to AASB staff that a revenue-based method, using the numbers of viewers attracted by different broadcasts of a film, would give the same result as the use of the units of production method. Production is an output of the entity's activities; the rate of usage of that production by customers does not necessarily reflect the rate of production. Unless there is consensus among practitioners regarding the meaning of 'future economic benefits' being consumed as assets are depreciated or amortised, and this is difficult to envision (given the broad meaning of 'future economic benefits' implicit in IAS 16 and IAS 38), there is potential for confusion regarding the circumstances in which a revenue-based depreciation or amortisation method would give the same result as the units of production method. Comment letter no. 1 on AASB ED 231 (see Agenda Paper 13.4) recommends integrating the discussion in paragraphs BC3 – BC5 of the Basis for Conclusions into the text of the amended Standards. One comment letter so far to the IASB argues instead that the Basis for Conclusions seems inconsistent with the proposed prohibition of applying a revenue-based depreciation or amortisation method.
- 24 AASB staff think this potential ambiguity is another reason to question whether the primary proposed amendment in IASB ED/2012/5 should be implemented. At the very least, AASB staff think that, if the IASB implements that proposal, it should clarify the relationship between the prohibition of a revenue-based depreciation or amortisation method and the related discussion in the Basis for Conclusions.

***Apparent scope limitation of technical and commercial obsolescence
(proposed new paragraphs 62B of IAS 16 and 98B of IAS 38)***

- 25 AASB staff agree with the ED's proposed new paragraphs 62B of IAS 16 and 98B of IAS 38, except that they seem to indicate information about technical or commercial obsolescence of an output is relevant to depreciation or amortisation only when applying the diminishing balance method of depreciation or amortisation. Such a 'scope limitation' of commercial obsolescence would seem consistent with the IASB's primary proposal to prohibit a revenue-based method of depreciation or amortisation, because none of the other depreciation or amortisation methods specifically mentioned in paragraphs 62 of IAS 16 and 98 of IAS 38 would seem to cater for commercial obsolescence.
- 26 However, because AASB staff disagree with prohibiting, in all cases, a revenue-based method of depreciation or amortisation, we disagree with the apparent scope limitation of commercial obsolescence referred to in paragraph 25 above. For example, using a revenue-based method of depreciation or amortisation to account for the period-by-period effects of expected commercial obsolescence would not necessarily involve a progressively diminishing depreciation or amortisation charge.
- 27 AASB staff think that, if the IASB were not to implement the primary proposed amendment in IASB ED/2012/5, adding proposed new paragraphs 62B of IAS 16 and 98B of IAS 38 would not be worthwhile, and the context of those paragraphs would be difficult to understand.

Description of the prohibited method of depreciation or amortisation

- 28 The IASB ED's proposed new paragraphs 62A of IAS 16 and 98A of IAS 38 describe as an inappropriate depreciation or amortisation method "A method that uses revenue generated from an activity that includes the use of an asset (intangible asset)". Paragraph BC1 of the Basis for Conclusions on the ED elaborates that: "A revenue-based depreciation or amortisation method is one that is derived from an interaction between units (ie quantity) and price, and that takes into account the expected future changes in price as the depreciation basis to allocate the amount of an asset that is to be depreciated or amortised."
- 29 AASB staff think that the pattern of depreciation or amortisation under a revenue-based depreciation or amortisation method might also vary as a result of expected changes over time in the market demand for outputs from an asset. That is, the pattern of revenue might vary without a change in unit prices. For example, this might occur in the circumstances discussed in paragraphs BC4 – BC5 of the Basis for Conclusions on the ED (specifically, a right to broadcast a film, for which the number of viewers declines quickly after a short time).
- 30 Therefore, AASB staff think that, if the IASB implements its proposal to prohibit applying a revenue-based depreciation or amortisation method, it should expand its description of a revenue-based depreciation or amortisation method to include reference to taking into account expected changes in the market demand for outputs from an asset. This would tie in with the reference to commercial obsolescence "arising from a change in the market demand for the product or service output of the asset" in paragraph 56(c) of IAS 16.

Other Issue: Transitional Provisions

- 31 IASB ED/2012/5 proposes that its new guidance should be applied retrospectively (consistently with the treatment of changes in accounting policy under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) [proposed paragraphs 81G of IAS 16 and 130G of IAS 38]. One of the comment letters thus far to the IASB argued that this proposal is inconsistent with the requirement in paragraph 61 of IAS 16 that “if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the [depreciation] method shall be changed ... [and] accounted for as a change in accounting estimate” (i.e., prospectively).⁷
- 32 AASB staff observe that the abovementioned existing requirement of IAS 16 requires prospective treatment of a change in depreciation method if there has been a significant change in the entity’s circumstances (an economic event). In contrast, a change in depreciation method resulting from the proposed amendment to IAS 16 would reflect a change of treatment only, and not account for an economic event. AASB staff think this distinction justifies treating a changed depreciation or amortisation method upon adopting the proposed amendments to IAS 16 and IAS 38 as a change in accounting policy, with retrospective application under IAS 8 (which requires such application to the extent practicable).
- 33 Therefore, AASB staff tentatively support the ED’s proposed transitional provisions, if the proposed changes in IASB ED/2012/5 are implemented by the IASB.

⁷ A similar requirement is set out in paragraph 104 of IAS 38.