

International Financial Reporting Standard

Clarification of Acceptable Methods of Depreciation and Amortisation

May 2014

BASIS FOR CONCLUSIONS – AMENDMENTS

[IAS 16 & 38 and IFRIC 12]

[Related to AASB 2014-4]

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Amendments to the Basis for Conclusions on IAS 16 *Property, Plant and Equipment*

Paragraphs BC33A–BC33G and their related heading are added. New text is underlined.

Depreciation: depreciation method

- BC33A The IASB decided to amend IAS 16 to address the concerns regarding the use of a revenue-based method for depreciating an asset. The IASB's decision was in response to a request to clarify the meaning of the term 'consumption of the expected future economic benefits embodied in the asset' when determining the appropriate amortisation method for intangible assets of service concession arrangements (SCA) that are within the scope of IFRIC 12 *Service Concession Arrangements*. The issue raised is related to the application of paragraphs 97–98 of IAS 38 *Intangible Assets* although the IASB decided to address the issue broadly, rather than limit it only to intangible assets arising in an SCA.
- BC33B The IASB observed that a revenue-based depreciation method is one that allocates an asset's depreciable amount based on revenues generated in an accounting period as a proportion of the total revenues expected to be generated over the asset's useful economic life. The total revenue amount is affected by the interaction between units (ie quantity) and price and takes into account any expected changes in price.
- BC33C The IASB observed that paragraph 60 of IAS 16 states that the depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. The IASB noted that even though revenue could sometimes be considered to be a measurement of the output generated by the asset, revenue does not, as a matter of principle, reflect the way in which an item of property, plant and equipment is used or consumed. The IASB observed that the price component of revenue may be affected by inflation and noted that inflation has no bearing upon the way in which an asset is consumed.
- BC33D On the basis of the guidance in IAS 16, the IASB proposed to clarify in the Exposure Draft *Clarification of Acceptable Methods of Depreciation and Amortisation* (Proposed amendments to IAS 16 and IAS 38) (the 'ED') that a method of depreciation that is based on revenue generated from an activity that includes the use of an asset is not appropriate, 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.
- BC33E During its redeliberations of the ED the IASB decided to reaffirm its conclusion that the use of a revenue-based method is not appropriate, because the principle in paragraph 60 of IAS 16 is that the "depreciation method shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity". A method that is based on revenue generated from an activity that includes the use of an asset would be, in contrast, a method based

on the generation of future economic benefits from the use of the asset. As a result of the feedback received on the ED, the IASB also decided not to retain the comments that it had included in the Basis for Conclusions on the ED on the limited circumstances in which a revenue-based method gives the same result as a units of production method. Many respondents to the ED found these comments contradictory to the guidance proposed in the Standard.

BC33F In the ED the IASB proposed to provide guidance to clarify the role of obsolescence in the application of the diminishing balance method. In response to the comments received about the proposed guidance the IASB decided to change the focus of this guidance. The IASB decided to explain that expected future reductions in the selling price of an item could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset. The IASB noted that the expectation of technical or commercial obsolescence is relevant for estimating both the pattern of consumption of future economic benefits and the useful life of an asset. The IASB noted that the diminishing balance method is an accepted depreciation methodology in paragraph 62 of IAS 16, which is capable of reflecting an accelerated consumption of the future economic benefits embodied in the asset.

BC33G Some respondents to the ED suggested that the IASB should define the notion of 'consumption of economic benefits' and provide guidance in this respect. During its redeliberations the IASB decided against doing so, noting that explaining the notion of consumption of economic benefits would require a broader project.

Amendments to the Basis for Conclusions on IAS 38 *Intangible Assets*

In paragraph BC72A the phrase ‘unit of production method’ has been amended to ‘units of production method’. New text is underlined.

Intangible assets with finite useful lives (paragraph 98)¹³

- BC72A The last sentence of paragraph 98 previously stated, ‘There is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method.’ In practice, this wording was perceived as preventing an entity from using the units of production method to amortise assets if it resulted in a lower amount of accumulated amortisation than the straight-line method. However, using the straight-line method could be inconsistent with the general requirement of paragraph 38 that the amortisation method should reflect the expected pattern of consumption of the expected future economic benefits embodied in an intangible asset. Consequently, the Board decided to delete the last sentence of paragraph 98.

Paragraphs BC72B–BC72M and their related headings are added. New text is underlined.

Amortisation method (paragraphs 97–98C)

- BC72B The IASB decided to amend IAS 38 to address concerns regarding the use of a revenue-based method for amortising an intangible asset. The IASB’s decision was in response to a request to clarify the meaning of the term ‘consumption of the expected future economic benefits embodied in the asset’ when determining the appropriate amortisation method for intangible assets of service concession arrangements (SCA) that are within the scope of IFRIC 12 *Service Concession Arrangements*. The issue raised is related to the application of paragraphs 97–98 of IAS 38, although the IASB decided to address the issue broadly, rather than limit it only to intangible assets arising in an SCA.
- BC72C A revenue-based amortisation method is one that allocates an asset’s amortisable amount based on revenues generated in an accounting period as a proportion of the total revenues expected to be generated over the asset’s useful economic life. The total revenue amount is affected by the interaction between units (ie quantity) and price and takes into account any expected changes in price. The IASB observed that the price component of revenue may be affected by inflation and noted that inflation has no bearing upon the way in which the asset is consumed.
- BC72D The IASB observed that paragraph 97 of IAS 38 states that the amortisation method used shall reflect the pattern in which the intangible asset’s future economic benefits are expected to be consumed by the entity.
- BC72E On the basis of the guidance in IAS 38 the IASB proposed to clarify in the Exposure Draft *Clarification of Acceptable Methods of Depreciation and Amortisation* (Proposed amendments to IAS 16 and IAS 38) (the ‘ED’) that a method of

- amortisation that is based on revenue generated from an activity that includes the use of an asset is not appropriate, 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.
- BC72F During its redeliberations of the ED the IASB decided to include a rebuttable presumption that revenue is generally presumed to be an inappropriate basis for measuring the consumption of the economic benefits embodied in the intangible asset. The IASB also considered the question of whether there could be circumstances in which revenue could be used to reflect the pattern in which the future economic benefits of the intangible asset are expected to be consumed.
- BC72G In finalising the proposed amendments to IAS 38, the IASB decided to make clear in the Standard that the presumption precluding the use of revenue as a basis for amortisation could be overcome in two circumstances. One of those circumstances is when it can be demonstrated that revenue is highly correlated with the consumption of the economic benefits embodied in an intangible asset. The IASB also noted that another circumstance in which revenue could be used is when the right embodied by an intangible asset is expressed as a total amount of revenue to be generated (rather than time, for example), in such a way that the generation of revenue is the measurement used to determine when the right expires. The IASB noted that, in this case, the pattern of consumption of future economic benefits that is embodied in the intangible asset is defined by reference to the total revenue earned as a proportion of the contractual maximum and, consequently, the amount of revenue generated contractually reflects the consumption of the benefits that are embodied in the asset.
- BC72H The IASB also analysed situations in which an intangible asset is used in multiple activities to provide multiple revenue streams. Some respondents commented that the application of a units of production method did not seem practicable, because the units of production were not homogeneous. For example, the producer of a motion picture will typically use the intellectual property embodied in the film to generate cash flows through exhibiting the film in theatres, licensing the rights to characters to manufacturers of toys and other goods, selling DVDs or digital copies of the film and licensing broadcast rights to television broadcasters. Some respondents thought that the best way to amortise the cost of the intellectual property embodied in the film was to use a revenue-based method, because revenue was considered a common denominator to reflect a suitable proxy of the pattern of consumption of all the benefits received from the multiple activities in which the intellectual property could be used.
- BC72I The IASB acknowledged that determining an appropriate amortisation method for situations in which an intangible asset is used in multiple activities, and generates multiple cash flow streams in different markets, requires judgement. The IASB considered suggestions that an intangible asset should be componentised for amortisation purposes in circumstances in which the asset is used to generate multiple cash flow streams. It observed that separating an asset into different components is not a new practice in business or in IFRS—it is

routinely done for property, plant and equipment and IAS 16 provides guidance in this respect—but refrained from developing guidance in this respect for intangible assets.

BC72J The IASB also decided to provide guidance on how an entity could identify an amortisation method in response to some respondents who observed that further guidance was required in the application of paragraph 98 of IAS 38, which is limited to providing a description of the amortisation methods most commonly used. During its deliberations the IASB determined that, when choosing an amortisation method, an entity could determine the predominant limiting factor for the use of the intangible asset. For example, a contract could be limited by a number of years (ie time), a number of units produced or an amount of revenue to be generated. The IASB clarified that identifying such a predominant limiting factor is only a starting point for the identification of the amortisation method and an entity may apply another basis if the entity determines that it more closely reflects the expected pattern of consumption of economic benefits.

BC72K In the ED the IASB proposed to provide guidance to clarify the role of obsolescence in the application of the diminishing balance method. In response to the comments received about the proposed guidance, the IASB decided to change the focus of this guidance to explain that expected future reductions in the selling price of an item that was produced using an intangible asset could indicate the expectation of technological or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset. The IASB noted that the expectation of technical or commercial obsolescence is relevant for estimating both the pattern of consumption of future economic benefits and the useful life of an asset. The IASB noted that the diminishing balance method is an accepted amortisation methodology in paragraph 98 of IAS 38, which is capable of reflecting an accelerated consumption of the future economic benefits embodied in the asset.

BC72L Some respondents to the ED suggested that the IASB should define the notion of 'consumption of economic benefits' and provide guidance in this respect. During its redeliberations the IASB decided against doing so, noting that explaining the notion of consumption of economic benefits would require a broader project.

Consistency in the use of the phrase 'units of production'

BC72M The IASB decided to make consistent the phrase 'units of production method' and has therefore amended the instances of the phrase 'unit of production method'.

Consequential amendment to the Basis for Conclusions on IFRIC 12 *Service Concession Arrangements*

In paragraph BC64, the phrase 'unit of production method' has been amended to 'units of production method'. New text is underlined.

Intangible asset (paragraph 26)

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- BC64 The IFRIC considered whether it would be appropriate for intangible assets under paragraph 26 to be amortised using an 'interest' method of amortisation, ie one that takes account of the time value of money in addition to the consumption of the intangible asset, treating the asset more like a monetary than a non-monetary asset. However, the IFRIC concluded that there was nothing unique about these intangible assets that would justify use of a method of depreciation different from that used for other intangible assets. The IFRIC noted that paragraph 98 of IAS 38 provides for a number of amortisation methods for intangible assets with finite useful lives. These methods include the straight-line method, the diminishing balance method and the units of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits.

Dissenting opinion

Dissent of Mary Tokar from *Clarification of Acceptable Methods of Depreciation and Amortisation* (Amendments to IAS 16 and IAS 38) as issued in May 2014

- DO1 Ms Tokar is dissenting from the publication of this amendment. She does not object to the IASB's objective of clarifying acceptable methods of depreciation and amortisation, nor to its conclusions to preclude revenue-based depreciation and nor to the introduction of a rebuttable presumption that revenue cannot be used as a basis for amortisation of intangibles. She also agrees that expectations of obsolescence should be considered when determining the useful life of an asset and selecting an amortisation or depreciation method that reflects the pattern of consumption of the asset. However, she is concerned that the amendments will not fully resolve the practice issue that was originally raised with the IFRS Interpretations Committee. She believes that the amendments are not sufficiently clear regarding what evidence is required to overcome the presumption and instead support the use of revenue as the basis for amortisation of an intangible asset. She believes that further guidance should be included to explain when the pattern of consumption of economic benefits is the same as the pattern in which revenue is generated.