Françoise Flores
Chairman
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Email: commentletters@efrag.org

30 January 2013

Dear Françoise

Draft Comment letter:
Exposure Draft *Clarification of Acceptable Methods of Depreciation and Amortisation: Proposed amendments to IAS 16 and IAS 38*

I am writing on behalf of the Financial Reporting Council in response to the EFRAG draft comment letter on the above Exposure Draft.

We agree with EFRAG that revenue-based methods of depreciation and amortisation may in some cases be appropriate, in particular where revenue is the best available evidence of the value of benefits consumed. We therefore disagree with the rationale adopted in the Exposure Draft, which, in our view, introduces a rule that is not founded on a clear or correct principle.

We agree that, given the unreliability of the assumptions on which depreciation calculations are based, standards should be clear that depreciation must be provided on a prudent basis, and suggest that IASB should consider alternative means of achieving this.

Our views are set out in more detail in the enclosed copy of our letter to the IASB.

If you would like to discuss these issues further please contact either Andrew Lennard or me.

Yours sincerely

Roger Marshall

Roger Marshall
Director, FRC and Chairman, Accounting Council

Financial Reporting Council

Hans Hoogervorst
Chairman
IASB
30 Cannon Street
London
EC4M 6XH

30 January 2013

Dear Hans

Exposure Draft *Clarification of Acceptable Methods of Depreciation and Amortisation: Proposed amendments to IAS 16 and IAS 38*

I am writing on behalf of the Financial Reporting Council in response to the above Exposure Draft.

As is more fully explained below, we agree that depreciation should reflect the consumption of economic benefits and support the objective of ensuring that depreciation is provided on a prudent basis. However, we disagree with the rationale set out in the Exposure Draft to justify its approach.

The Exposure Draft proposes to clarify that a method that uses revenue generated from an activity that includes the use of an asset is not an appropriate depreciation method. We disagree with that principle. In our view, an economic perspective of the consumption of economic benefits may, in some cases, require~~s~~ consideration of the value of those benefits—and revenue will often be the best available evidence of that value. The consumption of benefits cannot always be quantified simply by reference to the passage of time or the amount of use made by the asset. We note that IAS 38 states that the benefits flowing from an asset may include revenue from the sale of products or services.

The Exposure Draft discusses two cases where the value of future revenues is relevant to depreciation.

(i) The Basis for Conclusions gives the example of rights to broadcast a film where depreciation would reflect the value obtained on each transmission. The Exposure Draft claims that this gives the same result as the units of production method, but this is unconvincing as it is more plausible to use as the ‘unit’ each transmission, rather than the number of viewers attracted. The licence would presumably specify the number of transmissions: it cannot regulate the number of viewers.

(ii) The Exposure Draft acknowledges that an expected future <u>reduction</u> in unit selling price due to obsolescence may be relevant to depreciation. (It suggests that this is only the case where a diminishing balance method is used, but we do not agree that obsolescence is irrelevant if another method, such as straight-line, is used).

It seems that revenue-based methods are acceptable in these circumstances because they result in earlier rather than later amortisation, as noted in the last sentence of BC4. It therefore seems that the aim of the Exposure Draft is to ensure that depreciation and amortisation are not unduly deferred. We support that objective.

Depreciation and amortisation necessarily entail the making of estimates of uncertain future events, including changes in market prices for both costs and output. The approach adopted for depreciation therefore needs to be prudent. Before its revision in 2010, the Framework described prudence as ‘the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.’ We agree with your recent observation at the FEE Conference on Corporate Reporting of the Future in Brussels that this is ‘spot on’.

There is therefore a case for standards to ensure that the lack of reliability of estimates of the future is reflected in a prudent approach to depreciation. The proposals in the Exposure Draft are one way of addressing one particular aspect of this issue, and might therefore be acceptable as a short-term solution if there is evidence of a pressing problem. However, they have the drawback of adding a rule, which is not founded on a clear principle and, in our view, incorrect. We therefore suggest that the IASB consider alternative approaches, such a complete prohibition of depreciation and amortisation that is less prudent than a given bench mark, or creating a rebuttable presumption that the method used should be at least as prudent as straight-line, with disclosure of the reasons and effect in cases where that presumption is rebutted.

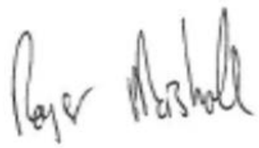
We support the approach of working on standards and Framework at the same time so that work on one can inform the other. The issues raised in the Exposure Draft provide a clear demonstration of the importance of the concepts of reliability and prudence. We hope therefore that work on this project will be considered in the development and completion of the Framework and result in appropriate treatment on these concepts.

In the specific context of depreciation there are a number of further issues that arise. It would not be practicable or appropriate for the Framework to deal with the subject comprehensively. However, it should perhaps be borne in mind that a research project on depreciation might be useful once work on the measurement part of the Framework is sufficiently advanced.

The Appendix to this letter responds to the specific questions raised in the Exposure Draft.

If you would like to discuss these issues further please contact either Andrew Lennard or me.

Yours sincerely



Roger Marshall
Director, FRC and Chairman, Accounting Council

Appendix

Question 1

The IASB proposes 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. This is because it 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. Do you agree? Why or why not?*

We do not agree.

As stated in the covering letter, we do not think that the consumption of economic benefits can meaningfully be quantified in all cases without reference to the value of those benefits.

However, we support the objective of ensuring that depreciation methods are selected on a prudent basis, reflecting the lack of reliability of estimates of future revenues and expenses.

Question 2

Do you have any other comments on the proposals?

We would add the following comments:

1 The proposed new paragraph 62A of IAS 16 states that paragraph 60 establishes consumption of the benefits that were inherent in the asset <u>when it was acquired</u> as the principle for depreciation. This is untrue: paragraph 60 does not refer to the time of acquisition. It is also inconsistent with paragraph 61 which, in our view correctly, requires the expected pattern of consumption to be reviewed at least annually and changes to be reflected in depreciation.

A similar point arises in IAS 38: the words 'when it was acquired' in the proposed new paragraph 98A are inappropriate, and do not feature in paragraph 97. An annual review of the pattern of consumption is required by paragraph 104.

2 As noted in the covering letter, we do not agree that obsolescence is only relevant where a diminishing balance method of depreciation is used, as implied by new paragraph 62B to IAS 16, new paragraph 98B to IAS 38 and BC6.

3 The Basis for Conclusions addresses the treatment of some assets where an accelerated method of depreciation would be appropriate. This is an important exception to the principle of the Exposure Draft and should be reflected in the standard, not only in the Basis for Conclusions.