EFRAG
European Financial Reporting Advisory Group

DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON CLARIFICATION OF ACCEPTABLE METHODS OF DEPRECIATION AND AMORTISATION – AMENDMENTS TO IAS 16 AND IAS 38

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

Comments should be sent to commentletters@efrag.org by 17 July 2014

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the IASB's *Clarification of Acceptable Methods of Depreciation and Amortisation – Amendments to IAS 16 and IAS 38* (the 'Amendments'). In order to do that, EFRAG has been carrying out an assessment of the Amendments against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

A summary of the Amendments is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions on Appendix 2 and 3.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

Financial Reporting Council

(b) Are you a:

☐ Preparer ☐ User ☒ Other (please specify)

Regulator

(c) Please provide a short description of your activity:

Financial regulator and standard setter

(d) Country where you are located:

United Kingdom

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2 EFRAG's initial assessment of the Amendments is that they meet the technical criteria for endorsement. In other words, they are not contrary to the principle of true and fair view and they meet the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No.

3 EFRAG is also assessing the costs that are likely to arise for preparers and for users on implementation of the Amendments in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment of costs are set out in paragraphs 7 and 11 of Appendix 3. To summarise, EFRAG's initial assessment is that is that the Amendments are likely to result in some one-off costs and insignificant ongoing costs for preparers while they are likely to result in insignificant one-off and ongoing costs for users.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

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4 In addition, EFRAG is assessing the benefits that are likely to be derived from the Amendments. The results of the initial assessment of benefits are set out in paragraphs 16 of Appendix 3.

To summarise, EFRAG's initial assessment is that that users and preparers are likely to benefit from the Amendments, as the information resulting from them will (a) remove inconsistency in determining the amortisation method of intangible assets and therefore reduce complexity; and (b) increase relevance, reliability and comparability of financial information and therefore enhances users' analysis.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

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5 EFRAG's initial assessment is that the benefits to be derived from implementing the Amendments in the EU as described in paragraph 4 above are likely to outweigh the costs involved as described in paragraph 3 above.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

6 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments.

Do you agree that there are no other factors?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

Appendix 1

A summary of the Amendments

Background

1 There has been uncertainty in practice as to whether depreciation of a tangible asset and amortisation of an intangible asset based on revenue would be in compliance with the requirements of the related standards. The Amendments clarify:

(a) in IAS 16 *Property, Plant and Equipment,* 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 as required by the standard; and

(b) in IAS 38 *Intangible Assets,* that there is a rebuttable presumption that an amortisation method based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate.

2 This presumption can be rebutted – and therefore the revenue to be generated can be an appropriate basis for amortisation of an intangible asset– only in the limited circumstances:

(a) in which the intangible asset is expressed as a measure of revenue; or

(b) when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

3 Furthermore, the Amendments clarify in both Standards that expected future reductions in the selling price of an item that was produced using an asset in the scope of IAS 16 and IAS 38 could indicate the expectation of technical or commercial obsolescence of the asset, which might affect the estimates on both the pattern of consumption of future economic benefits and the useful life of an asset.

When do the Amendments become effective?

4 The Amendments should be applied prospectively for annual periods beginning on or after 1 January 2016, with early application permitted.

Appendix 2

EFRAG's Technical assessment of Amendments against the endorsement criteria

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for EU endorsement?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments:

(a) are not contrary to the principle of 'true and fair view' set out in Article4(3) of Council Directive 2013/34/EU; and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt the Amendments.

Approach adopted for technical evaluation of the Amendments

3 EFRAG observed that the uncertainty that had arisen in practice related to amortisation of intangible assets. The amendments (that affect paragraph 56 and add paragraph 62A in IAS 16 *Property, Plant and Equipment*, and that affect paragraph 92 of IAS 38 *Intangible Assets)* are not deemed to result in changes in current practice. Therefore these amendments are not discussed specifically in this appendix. In performing its overall assessment, EFRAG focused on the impact of the new requirements introduced by the Amendments that involve changes to the current amortisation requirements in IAS 38.

Relevance

4 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

5 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or *whether it would result in th*e omission of relevant information.

6 EFRAG notes that the Amendments produce supplementary guidance designed to ensure greater consistency in applying the general amortisation requirement for intangible assets. As a result they are expected to contribute to greater relevance of the information provided.

7 In EFRAG's view, only in rare circumstances would an entity produce information that is not relevant. Such circumstances might arise when an entity does not have sufficient evidence to rebut the presumption, even though it might be more appropriate to do so.

8 EFRAG's overall initial assessment is that the Amendments would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

9 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

10 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness

11 EFRAG understands that the Amendments reduce subjectivity by providing guidance to entities that find it difficult to determine the pattern in which the intangible asset's future economic benefits are expected to be consumed. They also clarify when the use of revenue as a basis for amortisation faithfully represents the pattern of consumption of economic.

12 Furthermore, the Amendments shall be applied prospectively. In EFRAG's view, prospective application of these amendments results in financial information that is unbiased because it prevents the undue use of hindsight; therefore, the Amendments ensure a minimum level of reliability.

13 EFRAG's overall initial assessment is that the Amendments would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

14 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

15 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

16 EFRAG believes that the Amendments will bring more consistency in determining the amortisation method because they clarify the circumstances where the presumption can be rebutted, and thereby result in financial information that is comparable.

17 Furthermore, EFRAG believes that the Amendments will permit entities to determine the amortisation method differently where the patterns of consumption of the economic benefit embodied in the intangible asset are not economically similar. In EFRAG's view, this prevents the undue use of the straight line method of amortisation where it does not reflect the appropriate pattern of consumption.

18 However, in the rare cases identified in paragraph 7, where information produced by the Amendments is not relevant, comparability would be reduced.

19 Therefore, EFRAG's overall initial assessment is that the Amendments satisfy the comparability criterion.

Understandability

20 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

21 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

22 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

23 In EFRAG's view, the Amendments will reduce complexity in applying the general amortisation requirement for intangible assets because they clarify the circumstances where the use of a revenue based amortisation method is permitted. Therefore, we believe that the Amendments result in financial information that is understandable.

24 Furthermore, in EFRAG's view, the current disclosure requirements both in IAS 38 and in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* will address the impact of the Amendments and result in financial information that is understandable in the limited circumstances where entities rebut this presumption.

25 In EFRAG's view, the Amendments do not introduce any new complexities that may impair understandability. Therefore, EFRAG's overall initial assessment is that the Amendments satisfy the understandability criterion in all material respects.

True and Fair

26 EFRAG's initial assessment is that the information resulting from the application of the Amendments would not be contrary to the true and fair view principle.

European public good

27 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt Amendments.

Conclusion

28 For the reasons set out above, EFRAG's initial assessment is that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend their endorsement.

Appendix 3

EFRAG's evaluation of the costs and benefits of the Amendments

1 EFRAG has also considered whether, and if so to what extent, implementing the Amendments in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

2 EFRAG observed that the Amendments that affect paragraph 56 of IAS 16 *Property, Plant and Equipment* and paragraph 92 of IAS 38 *Intangible Assets* aim to clarify current requirements in both Standards and are unlikely to result in changes in current practice for most preparers and users.

3 Based on EFRAG's assessment, the application of the Amendments that involve changes to the current amortisation requirements in IAS 38 will have a cost and/or benefit impact on preparers and/or users of financial information because those amendments change current accounting practice to a small degree; accordingly EFRAG has performed a specific assessment on the implementation of the introduction of a rebuttable presumption in IAS 38 and on the limited circumstances where it can be rebutted.

Cost for preparers

4 EFRAG has carried out an initial assessment of the cost implications for preparers resulting from the Amendments.

5 EFRAG believes that for some entities in industries in which the amendments are relevant (e.g. film/television industry), the amendments could lead to one-off costs for preparers if they have to change their previous method of amortisation. However, EFRAG believes that these costs are justified because that contributes to the overarching goal of achieving greater consistency, understandability and comparability.

6 Furthermore, EFRAG believes that the reduction in the degree of subjectivity that results from the Amendments is likely to reduce the overall costs both upon the implementation phase and on an ongoing basis for those preparers that are permitted to rebut the presumption in IAS 38.

7 Overall, EFRAG's initial assessment is that the Amendments are likely to result in some one-off and insignificant ongoing costs for preparers related to implementation of the Amendments.

Costs for users

8 EFRAG has carried out an initial assessment of the cost implications for users resulting from the Amendments.

9 Users are expected to incur some incremental costs to understand and incorporate the new requirements, resulting from the Amendments in circumstances where entities rebut the presumption in paragraph 98A, into their analyses.

10 However, EFRAG believes that there are two additional factors to consider:

(a) The reduction in the degree of subjectivity when an entity applies the exception is likely to provide users with information that is reliable and overall more comparable and, as a result, generate cost savings to users; and

(b) If the relevance and comparability of information is adversely affected by requiring entities to produce financial information on a basis that does not reflect actual facts, users may need to perform additional work to understand the effects of amortisation charges on the performance of entities.

11 Overall, EFRAG's initial assessment is that the Amendments are likely to result in insignificant costs for users.

Benefits for preparers and users

12 EFRAG has carried out an initial assessment of the benefits for users and preparers resulting from the Amendments.

13 EFRAG's assessment is that the Amendments will result in benefits for those preparers that will be permitted to rebut the presumption as explained in paragraph 5 above, while other preparers remain unaffected.

14 Furthermore, requiring prospective application of the Amendments will provide relief to those preparers that will be in a position to rebut the presumption in paragraph 98A.

15 Users are also likely to benefit from the Amendments to the extent that the information they obtain is less subjective, and as a result more reliable and comparable.

16 Overall, EFRAG's initial assessment is that users and preparers are likely to benefit from the Amendments, as the information resulting from them will (a) remove inconsistency in determining the amortisation method of intangible assets and therefore reduce complexity; and (b) increase relevance, reliability and comparability of financial information and therefore enhances users' analysis.

Conclusion

17 EFRAG's overall initial assessment is that the overall benefits of Amendments are likely to outweigh costs associated with applying them.