EXPOSURE DRAFT

AMENDMENT TO FRS

AMENDMENT TO

FRS 15 'TANGIBLE FIXED ASSETS' AND FRS 10 'GOODWILL AND INTANGIBLE ASSETS':

INTEREST METHODS OF DEPRECIATION

ACCOUNTING
STANDARDS
BOARD

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and should be dispatched so as to be received not later than 25 August 2000. All replies will be regarded as on the public record unless confidentiality is requested by the commentator.

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This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comment received before being issued in final form.

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PREFACE

This exposure draft proposes a limited amendment to FRS 15 'Tangible Fixed Assets' which will establish that methods of depreciation that are designed to take into account the time value of money in the allocation of the depreciable amount of a tangible fixed asset over its useful economic life should not be used.

These methods of depreciation are referred to in this exposure draft as 'interest methods of depreciation'. The most widely known such method is the annuity method.

Interest methods of depreciation have the effect of back-end loading the depreciation charge, ie reducing the depreciation charge in the earlier years of a tangible fixed asset's useful economic life and increasing the depreciation charge in later years.

The Board has concluded that, at present, the use of interest methods of depreciation should not be permitted, because of the lack of widespread support for moving to a different basis of depreciation for all assets. The Board has examined a number of the arguments advanced for the use of interest methods of depreciation in particular circumstances and concluded that these circumstances do not, in themselves, justify the use of interest methods in the absence of a general requirement to do so.

Paragraph 81 of FRS 15 notes that "Where the pattern of consumption of an asset's economic benefits is uncertain, a straight-line method of depreciation is usually adopted." A method of depreciation that is less conservative than a straight-line method would therefore be justifiable only where there is persuasive evidence that it provides an appropriate reflection of the consumption of economic benefits, having regard to factors such as physical deterioration, obsolescence and other factors as set out in paragraph 80 of FRS 15, and without regard to the time value of money. The Board believes that, where it can be demonstrated that these circumstances apply, it would not be appropriate to prohibit the use of a method of depreciation that is less conservative than straight-line. Accordingly, this amendment is not intended to introduce a general prohibition on the use of back-end loaded depreciation methods. The proposed new paragraph 81C provides guidance on the circumstances where a back-end loaded depreciation method would be acceptable.

For the reasons explained in paragraph 53I, this amendment does not apply to assets let on operating leases that are classified as fixed assets in accordance with SSAP 21 'Accounting for leases and hire purchase contracts', provided that the conditions set out in paragraph 81B are satisfied. It is expected that the implementation of the proposals in the Discussion Paper 'Leases: Implementation of a New Approach' would remove the need for this exemption.

Similar considerations apply to intangible as to tangible assets. Amendments are therefore also proposed to FRS 10 'Goodwill and Intangible Assets'.

Comments are welcome on any aspect of the proposals. In particular:

1. Do you agree that interest methods of depreciation or amortisation should not generally be used? Please state why you agree or disagree.

2. If you agree that interest methods of depreciation or amortisation should not generally be used:

   (a) do you agree that interest methods of depreciation should be permitted in the case of assets let on operating leases, provided that the conditions set out in paragraph 81B are satisfied?

(b) are there other circumstances in which use of an interest method of depreciation or amortisation should be permitted?

3. If you believe that it should generally be permissible to use interest methods of depreciation or amortisation:

   (a) are there any conditions that you believe should be satisfied before it is acceptable to use an interest method?

   (b) are there any circumstances where it would usually be inappropriate to use an interest method of depreciation or amortisation?

STATEMENT OF STANDARD ACCOUNTING PRACTICE

Amendment of FRS 15 'Tangible Fixed Assets'

1 Three new paragraphs 81A-81C are inserted immediately after paragraph 81 in FRS 15, as follows:

"81A **The annuity method, and other interest methods of depreciation that are designed to take into account the time value of money, should not be used to allocate the depreciable amount of a tangible fixed asset over its useful economic life.**

81B **Notwithstanding paragraph 81A, an interest method of depreciation may be used in the case of a tangible fixed asset that is leased to another party under an operating lease, as defined in SSAP 21 'Accounting for leases and hire purchase contracts', where the following conditions are satisfied:**

(a) the lease term represents a significant portion of the useful economic life of the asset;

(b) it is reasonably expected that, at any point in time during the lease term, the net present value of the future net cash inflows to be received by the lessor under the lease arrangement, together with the estimated net realisable value of the tangible fixed asset at the end of the lease term, will not be less than the carrying value of the tangible fixed asset; and

(c) the terms and conditions of the lease ensure that the lessee is unable to cancel the lease before the end of the lease term without the receipt by the lessor of adequate compensation, ie it is reasonably expected that, should the lessee cancel the lease at any point in time, the compensation to be received by the lessor, together with the estimated net realisable value of the tangible fixed asset at the time of cancellation, will be at least equivalent to the carrying value of the tangible fixed asset at that time.

81C In rare cases, it may be appropriate to adopt a method of depreciation that has the effect of back-end loading the depreciation charge,[*] where it can be demonstrated that the resulting allocation of depreciation reflects the expected pattern of consumption of economic benefits, without regard to the time value of money, after taking into account the factors set out in paragraph 80."

2 In Appendix IV to FRS 15, 'The development of the FRS', the following heading and new paragraphs 53A–53J are inserted immediately after paragraph 53:

"Annuity method and other interest methods of depreciation

53A Interest methods of depreciation take into account the time value of money when allocating the depreciable amount of a tangible fixed asset over its useful economic life. In other words, interest methods adjust the depreciation charge in respect of the economic benefits expected to be consumed each period to take into account the implicit interest cost of paying for those benefits some time before they are consumed.

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* *ie depreciation charges are lower in the earlier years of the tangible fixed asset's useful economic life and higher in later years.*

53B The annuity method of depreciation is a particular type of interest method of depreciation that is based upon the assumption that the pattern of consumption of economic benefits, before taking into account the time value of money, is evenly spread over the tangible fixed asset's life.

53C For example, suppose an asset cost £10,000, has an estimated useful economic life of five years and no residual value and the pattern of consumption of economic benefits is expected to be evenly spread over the five years. Ignoring the time value of money, depreciation would be charged at £2,000 per year (assuming the asset is not revalued). However, because the £10,000 cash outflow occurs when the asset is purchased, the economic cost of the benefits consumed in later years is greater, because of the implicit interest cost of paying for those benefits some years in advance of their consumption. Interest methods of depreciation take into account this implicit interest cost. This has the effect of back-end loading the depreciation charge, ie depreciation charges are lower in earlier years and higher in later years.

53D It may be concluded from the above discussion that, in principle, interest methods of depreciation more fairly reflect the economic cost of the benefits consumed in each accounting period. However, these methods are based upon a fundamentally different approach to depreciation from that generally adopted in practice. There appears to be no widespread desire to adopt such an approach in practice. The Board has examined a number of the arguments advanced for the use of interest methods of depreciation in particular circumstances and concluded that these circumstances do not, in themselves, justify the use of interest methods in the absence of a general requirement to do so.

53E For example, the Board has considered and rejected the proposition that interest methods of depreciation are appropriate for assets that are financed by debt. The implicit interest cost referred to in paragraph 53C should be distinguished from interest costs incurred in relation to the financing of the purchase of the asset. Interest methods of depreciation take into account the implicit interest cost relating to the timing of when economic benefits are expected to be consumed through the use of the asset, not any interest costs incurred by financing the purchase of the asset. The use of the tangible fixed asset will result in economic benefits being consumed, irrespective of how the asset was financed.

53F Another proposition considered and rejected by the Board is that the existence of a contract with a customer in respect of the outputs from the asset justifies the use of a depreciation method that is less conservative than straight-line. As noted in paragraph 81 of the FRS, where the pattern of consumption of an asset's economic benefits is uncertain, a straight-line method of depreciation is usually adopted. The existence of a customer contract does not assist in reducing the uncertainty of the pattern of consumption of economic benefits. A customer contract may set the price at which the services derived from the asset will be sold, but it does not fix the cost of economic benefits consumed in providing those services. In other words, setting a price for the outputs (the services derived from the asset) does not determine the cost of the inputs (the consumption of economic benefits through use of the asset).

53G After considering the above factors, the Board has concluded that the use of interest methods of depreciation should not be permitted at present.

53H In rare cases, it may be appropriate to adopt a method of depreciation that has the effect of back-end loading the depreciation charge, where it can be demonstrated that the allocation of depreciation reflects the expected pattern of consumption of economic benefits, without regard to the time value of money, after taking into account the factors set out in paragraph 80 of the FRS. For example, it may be appropriate to use the unit-of-production depreciation method, which may result in an allocation of depreciation that is less conservative than straight-line.

53I SSAP 21 'Accounting for leases and hire purchase contracts' requires a lessor to account for assets let on operating leases as fixed assets. However, the economic effect of the lease is that a significant portion of the lessor's interest in such an asset represents rent receivable rather than a direct interest in the physical asset. For the economic effect of such leases to be reflected in financial statements, it may be necessary to use an interest method of depreciation. It is expected that the implementation of the proposals in the Discussion Paper 'Leases: Implementation of a New Approach' would remove the need for this exemption.

53J The Board acknowledges that there are other instances where existing accounting standards permit entities a choice between alternative accounting methods. For example, provided certain conditions are met, entities may choose whether to state tangible fixed assets at historical cost or at a valuation. However, the existence of a choice of permissible methods in one area of financial reporting does not automatically justify extending a similar choice to other areas. In particular, the Board believes that the effects of stating assets at a valuation are more transparent, better understood and less likely to give a misleading impression of profit for the period than would be the selective use of interest methods of depreciation."

Amendment of FRS 10 'Goodwill and Intangible Assets'

3 FRS 10 is amended as follows:

(a) The last sentence of paragraph 31 is replaced with the following sentence:

"It is unlikely that there will be circumstances in which there is justification and evidence to support a method of amortisation for goodwill or intangible assets that is less conservative than straight-line."

(b) The text of paragraph 32 is replaced with the following:

"A method of amortisation that aims to produce a constant rate of return on the carrying value of an investment is not one that aims to reflect the pattern of depletion of goodwill or intangible assets. Hence, interest methods, such as the 'reverse sum of digits' method or the annuity method, are not appropriate methods of amortising goodwill or intangible assets."

Date from which effective

4 These [draft] amendments are effective for financial statements relating to accounting periods ending on or after [date to be inserted after exposure]. Earlier adoption is encouraged.

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