Restricting the use of revenue-based amortisation

Revenue and consumption 'highly correlated'?

May 2014, Issue 2014/08

IN THE HEADLINES

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> The amendments introduce severe restrictions on the use of revenue-based amortisation for intangible assets. We are likely to see a number of companies changing their accounting policy as a result.
>
> – Mike Metcalf
> KPMG's global IFRS business combinations and consolidation leader

What's the issue?

Intangible assets are sometimes amortised using methods based on the revenue that they generate. For example, films and video games often generate higher revenues in the earlier years of their life, so media companies often amortise the associated intangible assets in line with the pattern of these revenues. In such cases, expense recognition tends to be accelerated.

In response to this issue, on 12 May 2014 the IASB issued amendments[1] to clarify when revenue-based depreciation or amortisation methods are permitted.

1 *Clarification of Acceptable Methods of Depreciation and Amortisation (Amendments to IAS 16 and IAS 38).*

New restrictive test for intangible assets

The amendments to IAS 38 *Intangible Assets* introduce a rebuttable presumption that the use of revenue-based amortisation methods for intangible assets is inappropriate. This presumption can be overcome only when revenue and the consumption of the economic benefits of the intangible asset are 'highly correlated', or when the intangible asset is expressed as a measure of revenue – e.g. the right to operate a toll road until the operator has collected a sum of 10 million.

While this is not an outright ban, it creates a high hurdle for when revenue-based methods of amortisation may be used for intangible assets.

The phrase 'highly correlated' is a new term that is not used in other IFRSs. It was introduced to limit the use of revenue-based amortisation, because revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices, which are not directly linked to the consumption of the economic benefits embodied in the intangible asset. As a result, a company will need to demonstrate that there is more than just some element of relationship between revenue generation and the consumption of benefits.

Implications will vary for intangible assets

The potential impact of not applying revenue-based methods of amortisation will depend on the correlation between an alternative amortisation method based on consumption and revenue generation.

Assuming a change in accounting policy to adopt straight-line amortisation, media companies are likely to recognise less amortisation – and therefore higher profits – in earlier years. However, additional impairment charges may arise when there is a significant decline in future cash flows after the early years of an asset's useful life.

Revenue-based depreciation banned for property, plant and equipment

The amendments to IAS 16 *Property, Plant and Equipment* explicitly state that revenue-based methods of depreciation cannot be used for property, plant and equipment. This is because such methods reflect factors other than the consumption of economic benefits embodied in the asset – e.g. changes in sales volumes and prices.

In our experience, this ban will not have a significant impact on current practice.

Next steps

If you are likely to be affected by the amendments – because you use or are thinking of using revenue-based amortisation methods – you will need to consider the impacts for your business.

The amendments are effective for annual periods beginning on or after 1 January 2016, and are to be applied prospectively. Early application is permitted.

Find out more

For more information on the amendments, please speak to your usual KPMG contact or go to the IASB press release.

Publication name: *In the Headlines – Restricting the use of revenue-based amortisation*
Publication number: Issue 2014/08
Publication date: May 2014
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