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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **11 March 2008, London**

Project: **ED Annual Improvements Project—Comment Analysis**

Subject: **IAS 38 Unit of production method of amortisation (Agenda paper 8B, question 29)**

BACKGROUND

1. IAS 38 *Intangible Assets* paragraph 98 states:

   *'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.'* [emphasis added]

2. The Board has been informed that, in practice, the words 'rarely, if ever' in paragraph 98 have been interpreted as meaning 'never'. In developing IFRIC 12 *Service Concession Arrangements*, the IFRIC identified situations in which using the unit of production method of amortisation would be appropriate. However, if the expected pattern of consumption of the future economic benefits in the asset is weighted to the end of the asset's life, paragraph 98 is perceived as precluding the use of the unit of production method. The Board therefore proposed to amend IAS 38 to delete this sentence to resolve the issue.

3. This paper sets out a summary of the comments received in response to this proposal along with the staff's recommendations as to how the Board should respond to those comments.

Comment letter analysis

4. Of the 75 letters received on the ED, 29 commented specifically on this issue. Whilst the overwhelming majority supported the Board's proposals, a number also raised specific comments. The principle comments raised were as follows:

- BC5 of the ED might imply that only service concessions can use the unit of production method for amortisation.
- The change does not clarify the meaning of '*expected pattern of consumption of the expected future economic benefits embodied in the asset*'. Without clarifying this phrase, divergence is likely to continue to exist in practice.
- The amendment could result in the development of inappropriate methods of amortisation.
- The amendment could be achieved by deleting the words 'if ever' from paragraph 98, which would allow the unit of production method of amortisation without allowing other less suitable approaches.
- It might not be clear how the IFRIC reached its conclusion that 'interest methods of amortisation are not permitted under IAS 38' (IFRIC12.BC65) if the proposed amendment is made.

5. One commentator noted a perceived inconsistency between the treatment of a leased asset in IAS 17 *Leases* and IAS 38. The respondent argued that, in some situations, IAS 38 requires a renewal period to be taken into account in determining assets' lives. In determining the lease term, IAS 17 excludes options to extend a lease that are not at the lessee's discretion. [CL64][1]

Staff analysis

6. The staff notes that the basis for conclusions on the ED will not be the same as the basis for conclusions on the final standard. The staff believes that concerns

[1] The staff believes that this inconsistency is beyond the scope of the current project. The staff therefore proposes that the eligibility of the amendment for the annual improvements project be considered as part of a future annual improvements project.

that the change could be read as applying only to service concessions because of the wording of BC5 can be addressed in the wording of the basis for conclusions on the final amendment. The staff will circulate suggested wording as part of a ballot draft.

7. Some respondents noted that the revised wording does not explain the term '*expected pattern of consumption of the expected future economic benefits embedded in the asset*'. There is therefore a risk of divergence developing in the ways that entities apply this guidance:

> *For example, in the case of a bridge constructed under a concession contract, which has been classified according to the intangible model proposed by IFRIC 12* Service Concessions, *traffic at the beginning of the contract is considerably lower to that at the end of the contract as drivers become accustomed to taking a new route. In the case of a contract whose duration is based on a predefined number of cars crossing the bridge, it would seem appropriate to consider the number of cars using the bridge as the unit of production for purposes of amortising the intangible asset. However, should the contract have a duration based on a number of years, e.g. 10 years, but nevertheless having a lower volume of traffic at the beginning, would the Board, in light of the proposed amendment, still consider the number of cars crossing the bridge an appropriate measure of unit of production or would it be the number of years of the contract? [CL19]*

8. Whilst the staff accepts this point, the staff also notes that amortisation is, by its nature, an estimate. Different entities will estimate the way in which an asset delivers its benefits in different ways. Because different methods of amortisation and different estimates of asset lives might exist, IAS 38 requires that entities disclose the useful lives of assets (or the amortisation rates used) and the amortisation methods used.

9. The staff believes that it is in the nature of principle based standards that entities may arrive at different answers depending on the judgements and estimates they use. The fact that different entities may obtain a different number for the depreciation charge does not necessarily imply that further guidance is required. The issue is whether entities may obtain an inappropriate number for the depreciation charge.

10. Some commentators believed that the Board could achieve its goals by making more limited changes to IAS 38.98. In particular, some believed that the same effect could be achieved by deleting the words "if ever":

'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.'

11. Supporters of this approach believe that limiting the change to the removal of the words 'if ever' may result in the same effect but retain guidance in paragraph 98 stating that it will be rarely permissible to back-end load amortisation. In other words, it will continue to allow the unit of production method but reduce the risk of inappropriate methods of amortisation being used.

12. Whilst the staff believes that some methods of amortisation may be inappropriate, this is because they do not match the amortisation charge with the consumption of benefits. In the staff's view, the over-riding factor in determining whether a method is appropriate should be whether it matches the amortisation with the consumption of benefits, not whether there is more amortisation in later periods than earlier ones.

13. Furthermore, there may be a number of situations in which back-end loaded approaches may be appropriate, for example, licences in which the licence fee is based on sales or production may result in a total fee that increases over time as sales increase.

14. The staff also notes that retaining the word 'rarely' may nullify the effect of making the change. Practice may still read this as precluding the use of unit-of-production amortisation methods that result in higher depreciation charges in later years.

15. The staff does not therefore support the proposal in these comment letters.

16. Finally, the staff considered whether the proposed change would invalidate the IFRIC's arguments for prohibiting the use of 'interest methods of amortisation' in IFRIC 12.BC65.

17. The staff believes that the IFRIC prohibited the use of interest methods of amortisation because they do not match the amortisation to the *expected pattern of consumption of the expected future economic benefits embodied in the asset.*

Instead, they are intended to match amortisation with the financing cost of related debt to produce a combined level charge to income over the life of the project. The staff therefore believes that the proposed change does not invalidate the IFRIC's argument.

Conclusions and recommendation to the Board

18. The staff recommends that the Board proceed with its proposals to change IAS 38 to make clear that the standard does not preclude amortisation methods that result in less amortisation than a straight line method. In recommending this change, the staff proposes that the Basis for Conclusions be revised and enhanced to make clear that this amendment does not apply only to service concessions but applies to all intangible assets.