



Project **Tentative agenda decision**

Topic **IAS 38 *Intangible Assets* - Amortisation method**

Introduction

1. The IFRIC received two requests in July asking for guidance on the meaning of ‘consumption of economic benefits’ for an intangible asset with a finite useful life.
2. The two requests present similar issues which is why they are analysed together. The two submissions are reproduced in full for ease of reference in Appendices B and C.
3. The first request seeks guidance on how to determine whether the useful life should be time-based or units of production-based (Appendix B).
4. The second request is more specific as it asks for guidance on the determination of the rate of amortisation when measuring the useful life using the units of production method (Appendix C).

Objective

5. The objective of this paper is:
 - (a) To give an overview of previous discussions at Board or IFRIC meetings on this subject,
 - (b) To analyse the issues raised, and
 - (c) To recommend the IFRIC do not take the issue on to its agenda and to propose a wording for the agenda decision.

This paper has been prepared by the technical staff of the IASB. The views considered in this paper are for discussion at a public meeting of the IFRIC. No such views are to be presumed to be acceptable or unacceptable applications of IFRSs until the IFRIC or the IASB makes such a determination.

Decisions made by the IFRIC are reported in *IFRIC Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

Background

6. The table below summarises the previous discussions and their main outcome. For ease of reference, a detailed list of prior discussions is reproduced in Appendix D.

Meeting	Issue	Outcome
Board meeting December 2006 AIP ED	May a method of amortisation result in a lower cumulative amortisation than the straight-line method?	AIP ED, change in paragraph 98 of IAS 38.
Board meeting March 2008 CL analysis to AIP ED	In addition to the above request, constituents raised the issue of which of the straight-line or units of production method best reflect the consumption pattern of the future economic benefits	The Board did not specifically discuss this latter issue. The Board confirmed the change to paragraph 98 of IAS 38 in the final AIP 2008.

The issue

7. The questions raised today are similar to those raised in March 2008 and may be both summed up as “Can the “pattern of consumption of economic benefits” reflect values or only quantities?”
8. Both submissions reflect current practice that the basis for determining the amortisation method can be either:
 - (a) A consumption pattern based on revenue generated from the intangible asset, leading to the use of the units of production method for arrangements such as toll-roads;
 - (i) an additional question on the nature of the unit is whether it can be measured by reference to cash inflow streams rather than the number of users, or
 - (b) A consumption pattern based on the duration of the licence to operate the infrastructure, leading to the use of the straight-line method.
9. The constituents seek guidance on how to select one approach or the other. The concern is that lack of comparability is at stake across industries and geographical areas for economically similar arrangements.

Staff analysis

How to determine the amortisation method?

10. Paragraph 8 of IAS 38 *Intangible Assets* defines useful life as being either based on a period or on a number of production units. Paragraph 97 of IAS 38 refers to selecting the amortisation method to reflect the pattern in which the entity expects to consume the future economic benefits of the asset.
11. The staff notes that the use of the term “expects” entails judgement specific to the entity. However, the staff questions whether such judgement should result in similar arrangements having different amortisation methods to reflect different expectations of the consumption patterns from the entity’s point of view.
12. For example, for an arrangement granted for a given period of time, regardless of usage levels, could the licence be amortised using a units of production

method for the financial reporting purposes of one entity and using a straight-line method for the financial reporting purposes of another entity?

13. The staff acknowledges that for Concession Arrangements under IFRIC 12 *Service Concession Arrangements*, the use of the licence – be it accounted for as an intangible or as a financial asset – may reflect the use of the underlying tangible asset (eg the road in toll-road arrangements). Accordingly, the amortisation method should reflect the use of the underlying tangible asset rather than the use of the licence itself.
14. The staff notes that the above view is currently reflected in financial statements.
15. The staff believes that the entity should not be restricted when identifying an amortisation method as long as the method reflects an economic reality, and judgements and estimates are appropriately disclosed in the notes to the financial statements.
16. The staff is of the opinion that the variety of amortisation methods for similar arrangements is inherent to the entity's expectation of consumption of benefits from the asset.

Can revenue represent the units of production?

17. The next question raised in the second submission (Appendix C) is which of the usage level (quantity) or the revenue stream (value) best reflect the use of the asset, when using the units of production amortisation method.
18. The staff notes that in practice the number of users or units is often necessary to the determination of the cash inflows. The revenue stream is derived from the interaction between quantity and price, hence may not primarily represent the usage of the asset.
19. As a consequence, the staff believes that the units of production should be primarily based on the units that are directly obtained from the use of the asset rather than on derived computation, such as revenue.

What information is currently disclosed as regards amortisation methods?

20. The staff reviewed financial statements of groups with significant licences and noted that both the straight-line and the units of production methods were equally used.
21. However, in many cases the reason for the choice of the method is not disclosed.
22. The staff believes that the judgements made in determining the amortisation method should be clearly explained in the notes to the accounts.

Agenda criteria assessment

23. The staff's preliminary assessment of the agenda criteria is as follows:
 - (a) *Is the issue widespread and practical?*
Yes, the issue arises in all jurisdictions.
 - (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
As the submissions indicate, there are divergent interpretations.
However, in the staff's view explained above, these divergences are inherent to the interpretation of the definition of useful life.
 - (c) *Would financial reporting be improved through elimination of the diversity?*
Yes.
 - (d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*
Yes, however, the issue is in the nature of application guidance rather than interpretive guidance.
 - (e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)*
N/A. There are no planned or current IASB projects that the issue relates to.

Staff recommendation

24. Given the above analysis and the agenda criteria assessment, the staff recommends that the IFRIC do not add the issue to its agenda. The staff proposes a wording for a tentative agenda decision in Appendix A.

Recommendation and question for the IFRIC

Does the IFRIC agree not to take the issue to its agenda?

Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A?

[Appendix A has been omitted from this observer note]

Appendix B

The issue:

1. There are a variety of amortization methods used to allocate the depreciable amount of an asset on a systematic basis over its useful life, including the straight-line method, the diminishing balance method and the unit of production method. IAS 38 *Intangible Assets*, paragraph 97, establishes that the amortization method used for an intangible asset with a finite useful life should reflect the pattern in which the future economic benefits embodied in the asset are expected to be consumed by the entity. If that pattern cannot be determined reliably, the entity must use the straight-line method.
2. The question arises as to whether there can be differing interpretations of what constitutes the 'economic benefits embodied in the asset'.
3. Using a license to operate a new toll road as an example: a new toll road was being built to connect the road network to a new town; the number of residents in the town would increase over time, and hence the traffic flow is also expected to increase; an entity is given a license to operate the toll road for 10 years regardless of usage levels during that period and the license would be classified as an intangible asset.
4. One view would be that the economic benefits associated with the license arise out of the usage of the road and hence revenue generated from the traffic flow. Under this view the pattern of consumption of those benefits would be driven by actual traffic volumes leading to a unit of production amortization method (i.e. license amortisation based on actual traffic volumes compared to the total expected volume over the 10 years).
5. An alternative view would be that the economic benefit embodied in the license is the right to operate the toll-road for a 10-year period. Under this view the units of production method of amortization would not be an appropriate method for intangible assets that do not have a finite productive capacity inherent in the asset. The right to operate for a specified period of time is expected to be "consumed" through the passage of time, and hence a straight-line amortization method is appropriate.
6. In order to prevent divergent practices, the Institute would like IFRIC to provide an interpretation on whether the term "economic benefits embodied in the asset" refers to revenue generated from the asset or refers to the asset itself.

Current practice:

7. Through a review of listed companies' financial statements, it is noted that both the straight-line method and the units of production method are commonly used in some jurisdictions for time-based intangible assets.
8. Extracts of some accounting policies from listed companies' financial statements are as follows:

✓ *Toll road operation rights (Straight-line method)*

"The toll road operation rights were recognised as an intangible asset and stated in the balance sheet at cost less subsequent accumulated amortization and accumulated impairment losses, if any. Amortisation of the toll road operation rights was charged so as to write off the cost of the asset over the unexpired term of the operation rights using the straight-line method."

✓ *Toll road operating right (Units of production method)*

"Toll road operating right is stated at cost less amortization and any accumulated impairment losses. Amortisation is provided to write off the cost of toll road operating right on a units-of-usage basis, calculated based on the proportion of actual traffic volume for a particular period to the projected total traffic volume over the periods for which the Group is granted the rights to operate the toll road."

Reasons for IFRIC to address the issue:

(a) Is the issue widespread and practical?

Through the research performed, with the assistance of the large audit firms, we believe that divergence is widespread. In some jurisdictions the use of a units of production approach to amortize rights to operate infrastructure projects (that are accounted for as intangible assets) is common. In others it is rare. A revenue-based approach is common for film rights and more generally in the entertainment industry, whereas telecommunication licences tend to be amortized on a straight line basis. It is important to develop a principle to address the inconsistencies across industries and geographical boundaries.

(b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As outlined above - there are currently two broad schools of thought on the meaning of "consumption of economic benefits" of a time-based intangible asset: a time based view (the straight-line amortization approach) and a usage based view (the units-of-usage or revenue-related amortization depreciation method), which would lead to different accounting treatment for economically similar arrangements.

(c) Would financial reporting be improved through elimination of the diversity?

Financial reporting would be improved greatly by clarifying this issue since a consistent approach would enhance comparability among companies' financial reporting.

(d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is insufficient to apply the interpretation process?

We are of the opinion that the issue is sufficiently narrow in order to be addressed by an interpretation of IFRIC.

(e) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than IFRIC would require to complete its due process).

We are not aware that there is any current or planned IASB project relating to amortization of intangible assets, or indeed more broadly to IAS 38.

Appendix C

Introduction

In some jurisdictions, the Government has introduced expressway concession arrangements to attract private sector participation in the development, financing, operation and maintenance of expressways. Such arrangement typically involves the granting of exclusive right and authority by the Government to the Concession Company to undertake the following activities and to enjoy the concession relating to an expressway:

Infrastructure

1. Design and construction of a new expressway or new sections forming a larger expressway network; and/or
2. Taking over, design and upgrading an existing expressway or existing sections forming a larger expressway network.

Operations and maintenance

3. Management, operations and maintenance of the expressway or sections of the expressway referred in Items 1 and 2 over the concession arrangement period; and
4. Management, operations and maintenance of ancillary facilities.

Economic benefit

5. Collection and retention of toll amounts for the Concession Company's own benefit from vehicles using the expressway over the concession arrangement period.

The Concession Company's right and authority pursuant to the Concession Agreement ceases upon the end of the concession period, where the management, operations and maintenance of the expressway (including the ancillary facilities) shall be reverted to the Government.

Toll

The Concession Agreement specifies the agreed toll rates throughout the concession period, calculated based on an agreed-upon structure and the projected traffic volumes. The agreed-upon structure provides for rate increase in every specific interval. Nearer to the rate increase date, however, the Government may gazette a lower toll rate than the agreed toll rate. In such event, the Government shall compensate the Concession Company within the means of the agreed-upon structure.

Government may compensate the Concession Company through the following methods (individually or in combination):

- Cash payment
- Extension of concession period
- Income tax exemption

Expressway Development Expenditure

In the books of most Concession Companies in such jurisdictions, Expressway Development Expenditure (“EDE”) comprises development and upgrading (design and construction) expenditure, including interest charges relating to financing of the development incurred in connection with the expressway concession. EDE is stated at cost less accumulated amortisation and impairment losses [IAS38.24 and IAS38.74].

EDE is amortised over the concession period. Most Concession Companies apply the following amortisation formula in arriving at the annual amortisation charge for each financial year:

$$\text{Annual amortisation} = \frac{\text{Toll revenue for the year}}{\left(\begin{array}{l} \text{Actual toll revenue for} \\ \text{the year} \end{array} + \begin{array}{l} \text{Projected toll revenue} \\ \text{for the subsequent} \\ \text{years to the end of the} \\ \text{concession period} \end{array} \right)} \times \left(\begin{array}{l} \text{Net book} \\ \text{value of} \\ \text{EDE at the} \\ \text{beginning} \\ \text{of the year} \end{array} + \begin{array}{l} \text{Additions} \\ \text{for the} \\ \text{year} \end{array} \right)$$

Amortisation Method based on Projected Revenue

The abovementioned amortisation method is used by most Concession Companies based on the following justifications:

1. Toll rates are pre-determined and scheduled in the concession agreement in such a way that a lower rate is imposed at the beginning of the concession period and increase periodically under a higher rate at the end, so that the users of the expressway are not subjected to heavy burden at the initial years and the toll rate increase in subsequent years is in tandem with the users’ ability to pay (i.e. planned economic growth rate);
2. Toll rates are not linked to the inflation rates, i.e. fluctuations in the inflation rates will not change the scheduled increase in the toll rates;
3. Even when the Government does not approved the scheduled toll rate increase to be imposed, the difference will be compensated by the Government and effectively, the toll rates are guaranteed return to the toll concessionaires; and
4. This amortisation method reflects the expiring rights to collect toll (which the intangible asset represents) by the realisation of revenue and hence, represents the expected pattern of consumption of the expected future economic benefits embodied in the asset.

Criticisms / Arguments

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life – in the case of an expressway concession, the useful life shall be the concession period. The method used shall be based on the expected pattern of consumption of the expected future economic benefits embodied in the concession asset.

There are arguments that the above amortisation method adopted by most Concession Companies does not reflect the pattern in which the asset's future economic benefits are expected to be consumed by the Concession Company.

In the abovementioned amortisation method, toll rate increase is factored in the calculation of annual amortisation charge. Given that the concession agreement allows the Concession Company to revise the toll rates in every specific interval, the annual amortisation charge in earlier years would be lower than subsequent years, assuming a consistent traffic volume year-on-year.

Critics of the abovementioned method asserted that an amortisation method based on projected traffic volume (rather than projected revenue) is more reflective of the expected pattern of consumption of the expected future economic benefits embodied in the concession asset.

Matter for Discussion

Views are sought on whether the abovementioned amortisation method is acceptable, taking into consideration IAS38.97.

Appendix D

- D1. The issue of the determination of the useful life for intangible assets with definite life was raised in 2006 when the IFRIC was dealing with the project on concession arrangements that lead to the publication of IFRIC 12.
- D2. It was then noted that, in concession arrangements, a useful life based on units expected to be obtained from the asset usually may well reflect the economic reality, especially when the consumption pattern is weighted to the end of the asset's life as the volume of users increase {from AP 10C December 2006 & AP 8B March 2008 Board meetings}.
- D3. The issue was whether the units of production method could be used if it resulted in a lower cumulative amortisation than the straight-line method. Constituents mainly understood paragraph 98 (before it was amended in 2008) of IAS 38 as forbidding the use of methods other than the straight-line method if they entailed lower cumulative amortisation.
- D4. This issue was addressed in the Annual Improvements Project (AIP) ED published in 2007, by removing the last sentence of paragraph 98 of IAS 38.
- D5. While commenting on this issue, some constituents raised concerns on which of both methods (straight-line or units of production) best reflect the consumption pattern of the future economic benefits {from AP 8B March 2008 Board meeting}.
- D6. This latter issue was analysed as part of the comment letters analysis for 2008 AIP presented at the Board meeting in March 2008. The basis for discussion was that amortisation is an estimate by nature and that entities may arrive at different answers depending on the judgements and estimates they use.{AP 8B March 2008 Board meeting}.
- D7. The Board concluded that the principle in paragraph 97 of IAS 38 [...] is sufficiently clear and reaffirmed its proposal to remove the last sentence of paragraph 98 of IAS 38.