Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through email (ifric@iasb.org)

16 December 2009

Mr. Robert Garnett
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Garnett,

Tentative agenda decision: IAS 38 *Intangible Assets* – Amortization Method

We would like to express our disappointment of the tentative decision not to take onto the IFRIC's agenda our request dated 27 July 2009 (**Annex I**) for an interpretation of IAS 38 *Intangible Assets* with respect to providing guidance on the meaning of "consumption of economic benefits" of an intangible asset with a finite useful life. We believe that the IFRIC's decision may be in part due to the IFRIC not fully understanding the issue posed to them, and hence we have clarified this below.

IAS 38 requires the method of amortisation used to be "selected on the basis of the expected pattern of consumption of the future economic benefits embodied in the asset". It is, however, unclear whether the future economic benefits established in the asset represent its ability to:

(a) contribute to the generation of future revenues, which will be 'used up' as those revenues are generated (a revenue approach to amortisation);
(b) contribute to the generation of future profits, which will be 'used up' as those profits are generated (a profit-based approach to amortisation);
(c) produce units of output, or perform services (including, for example, the passage of vehicles on a toll road) *based on the maximum productive capacity of the asset* (a time based approach to amortisation, where the maximum productive capacity of the asset is constant in each time period and the asset has a time-based rather than output-based life, or a units of production approach to amortisation, where the asset is able to produce a finite number of units of output); or
(d) produce units of output, or perform services (including, for example, the passage of vehicles on a toll road) *based on the expected output of the asset* (a units of production approach to amortisation)

or whether the entity may elect any of these methods given the lack of clarity in IAS 38 (and IAS 16). One view adopted in practice is that only method (c) is acceptable, as revenues, profits and expected output are not features of the asset being amortised, but factors associated with the environment in which it will be used. The alternative view also applied in practice is that the asset is not used in isolation, and hence the method of amortisation should reflect the economic benefits arising from its use in the

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environment in which it is expected to be used. Under this view, all of the options would be acceptable.

The IFRIC's unwillingness to address the interpretation of this phrase has resulted in divergent practices in Hong Kong and China and, based on comments received from the National Standard Setters group, in other jurisdictions. This ambiguity is also noted by the Stock Exchange of Hong Kong in its published review report, which was comprehended in our letter dated 27 July 2009.

We therefore respectfully ask the IFRIC to reconsider adding this project to its agenda and to publish guidance that will ensure that the phrase is interpreted consistently by preparers of financial statements.

If you have any questions on our comments, please do not hesitate to contact me at mailto:ong@hkicpa.org.hk.

Thank you.

Yours sincerely,

Steve Ong

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Director, Standard Setting

SO/ac

CPA
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Annex I

Our Ref.: C/FRSC

Sent electronically through the email at ifric@iasb.org

27 July 2009

IFRIC Co-ordinator
International Accounting Standards Board
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Dear Sirs,

Request for IFRIC Agenda Item – Clarification on the application of "consumption of economic benefits" in IAS 38 *Intangible Assets*

In adopting IAS 38 *Intangible Assets*, we have observed that there are divergent practices in Hong Kong and China regarding the basis of amortization of time-based intangible assets with a finite useful life (for example a licence to operate a toll-road for 10 years). Upon further investigation we identified that divergent practices also exist in European territories applying IFRS. While the examples that we provide relate to toll-roads, we note that the scope of IAS 38 is broader, and hence we believe that this is an issue with widespread applicability. We therefore request that IFRIC interpret the requirements of IAS 38 vis-à-vis amortization of intangible assets.

--- Appendix 1 to this letter sets out the issue and the divergent practices identified.
--- Appendix 2 considers the issue in light of the criteria for an IFRIC agenda item.
--- Appendix 3 is an extract of a copy of a public document on this issue from The Stock Exchange of Hong Kong.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong

Steve Ong, FCA, FCPA
Director, Standard Setting Department

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Appendix 1

IFRIC AGENDA ITEM REQUEST

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 licence 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 licence to operate the toll road for 10 years regardless of usage levels during that period and the licence would be classified as an intangible asset.

4. One view would be that the economic benefits associated with the licence 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. licence amortization 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 licence 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 Hong Kong and China 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. Amortization 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. Amortization 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."

9. The Stock Exchange of Hong Kong has also noted this matter in its published report[1], an extract of which is attached at Appendix 3. Please note paragraph 67 in particular.

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[1] The Stock Exchange of Hong Kong published a report in June 2009 summarising key observations and findings from its review of 100 financial reports released by listed issuers in 2007 and 2008. The full report is available at http://www.hkex.com.hk/listing/staffint/FRM2-09.pdf

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.

Submitted by

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- A majority of issuers disclosed two or more reportable segments in their financial statements. Issuers should however note that HKAS 14 *"Segment Reporting"* will be replaced by HKFRS 8 *"Operating Segments"* which is effective for financial periods commencing on or after 1 January 2009. The requirements of HKFRS 8 require the disclosure of segmental information based on the "management perspective", that is, how management manages the company and makes decisions. Comparative information in the first year of application of HKFRS 8 is required and therefore comparatives will need to be restated. Listed issuers should therefore study and understand the new accounting standard and ensure proper implementation of the new accounting standard in their future annual and interim financial statements.

56. We would also take this opportunity to specifically remind listed issuers that are not incorporated in Hong Kong that when preparing their annual reports the Listing Rules require them to provide certain disclosures required under provisions of the Hong Kong Companies Ordinance, including the Tenth Schedule (paragraph 28 of Appendix 16 to the Main Board Rules and its GEM Rules equivalent). Moreover, Main Board Rule 13.46(2) (and its GEM Rules equivalent) states that *"In the case of an overseas issuer or a PRC issuer... Such issuer shall send to ... every member of the issuer...a copy of ... its annual report including its annual accounts and, where the issuer prepares group accounts, its group accounts, together with a copy of the auditors' report thereon ..., not less than 21 days before the date of the issuer's annual general meeting and in any event not more than four months after the end of the financial year to which they relate."* There appear to be divergent practices in the interpretation of the rule in that some interpret the rule to only require the presentation of consolidated financial statements without the presentation of the financial statements of the issuer itself. The apparent reason for this interpretation is that under the current accounting standards the presentation of separate financial statements of the company is not normally required unless the company elects to present them or it is required by local regulations. Issuers should comply with the requirements under both the accounting standards and the Listing Rules.

FINDINGS REGARDING SPECIAL REVIEW THEME – ACCOUNTING FOR TOLL ROAD INFRASTRUCTURE FACILITIES

57. In this year's review, we chose an industry theme – the review of issuers whose major or principal activities included toll road investment, construction, operation and management. The review focused particularly on the accounting treatment adopted for transport infrastructure assets to determine whether there was compliance with the applicable accounting standards. Unless otherwise specified, HKFRSs and their paragraph numbers referred to in this section correspond with those in IFRSs.

Our observations

58. Under Hong Kong Interpretation 1 *"The Appropriate Accounting Policies for Infrastructure Facilities"* issued in 2004 (which was developed locally by the HKICPA with no corresponding IFRS), listed issuers are permitted to use either time-based approach (straight-line method) or traffic usage-based approach (units of production method) for amortisation of infrastructure facilities and the sinking fund method is not considered an appropriate method. We were pleased to note that none of the issuers reviewed adopted the sinking fund method.

59. In total, 13 toll road companies were selected for review and the accounting policies adopted are summarised below:-

- 5 issuers separated amounts attributable to toll road infrastructures from toll road operation rights and of these:-
  - 1 adopted the traffic usage-based method to amortise both toll road infrastructures and operation rights;
  - 1 adopted the time-based method to amortise both toll road infrastructures and operation rights; and
  - 3 adopted the traffic usage-based method to amortise toll road infrastructures and used the time-based method to amortise operation rights;
- 5 issuers only held toll road infrastructures and they all adopted the traffic usage-based method to amortise toll road infrastructures; and
- 3 issuers only held toll road operation rights and 2 adopted the traffic usage-based method and 1 used the time-based method.

60. We however noted that the issuers applied different formulae in calculating the amortisation/depreciation of infrastructure facilities under the usage-based approach.

Our comments and recommendations

61. Although a majority of listed issuers used the usage-based approach which is permitted, there appear to be different formulae applied in calculating amortisation/depreciation. No matter which formula is used, the amortisation/depreciation of assets with finite useful lives should be applied consistently and reviewed at least at each financial year end (see paragraph 104 of HKAS 38 *"Intangible Assets"* and paragraph 61 of HKAS 16 *"Property, Plant and Equipment"* respectively) and in particular projections of traffic volume.

62. Issuers should ensure that they have properly identified the relevant "asset" that is depreciated as the nature and classification of the asset may require a different accounting treatment, for example, the distinction between tangible infrastructures and operating rights.

63. We noted that very often incomplete information was disclosed on the amortisation/depreciation method adopted. Issuers sometimes stated the overall method used in the notes but omitted details on the practices in applying the method, in particular, the measurement basis and key assumptions used in the estimation of traffic volume. During our review, we requested the issuers to provide further explanations, including supporting documents, in order to obtain a clearer understanding of the method adopted.

64. Effective for annual accounting periods beginning on or after 1 January 2008, issuers are reminded to consider HK(IFRIC) Interpretation 12 *"Service Concession Arrangements"* which sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements.

65. Specifically, paragraph 11 of HK(IFRIC) Interpretation 12 provides that the operator's rights over the infrastructure should not be recognised as property, plant and equipment of the operator when the contractual service arrangement does not convey the operator the right to control the use of the public service infrastructure.

66. Moreover, HKAS 38 *"Intangible Assets"* provides some additional guidance and requires that in determining whether an asset that incorporates both intangible and tangible elements, an issuer is required to use judgement to assess which element is more significant (see paragraph 4 of HKAS 38).

67. HKAS 38 allows an issuer to use either time-based or usage-based approaches for amortisation of intangible assets. Paragraph 98 of HKAS 38 requires that the method used should be based on the expected pattern of consumption of the expected future economic benefits embodied in the asset, however, what constitutes "expected pattern of consumption" is unclear and this may require a decision on whether the time-based approach or usage-based approach should be adopted.

68. The usage-based approach based on traffic volume will normally result in a lower initial amortisation in the earlier years of the asset's life than the time-based method. Paragraph 97 of HKAS 38 specifies that if the expected pattern of consumption cannot be determined reliably, the straight-line method should be adopted.

CONCLUSION

69. We plan to continue to undertake a financial statements review programme and communicate the results to listed issuers on a regular basis.

70. We encourage all persons involved in or responsible for preparing financial information for listed issuers and their auditors to take note of the matters discussed in this report. Extra care and attention at the planning stage and other stages of the process leading to publication of financial information will ensure a proper outcome and useful information being presented to readers of financial statements.

- End -