

Project	Annual Improvements—2011-2013 cycle		
Paper topic	IAS 38 <i>Intangible Assets</i> and IFRIC 12 <i>Service Concession arrangements</i> – Selection of amortisation method		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Note: This paper has been reposted because the Appendices to the original submission (Appendix 1 and Appendix 2) were missing but they have now been included. This has not affected the content of this paper as the author had taken these Appendices into consideration in the analysis of this issue.

Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify the meaning of the term ‘consumption of the expected future economic benefits embodied in the asset’ when determining the appropriate amortisation method for intangible assets of service concession arrangements (SCA) which are within the scope of IFRIC 12 *Service Concession Arrangement*. This issue relates to the application of paragraphs 97 and 98 of IAS 38, *Intangible Assets*.
2. The request raises this issue in the context of a SCA where:
 - (a) the rate chargeable to users (hereinafter referred to as ‘tariff’) is contracted in the agreement and
 - (b) a lower tariff is imposed at the beginning of the concession and increases periodically in line with the grantor’s practice so as not to burden consumers.
3. More specifically, the submitter asks the Committee to consider whether:

- (c) a revenue-based amortisation method better reflects the economic reality of the underlying contractual terms or
 - (d) a time-based amortisation method is most appropriate as it reflects the duration of the SCA and the fact that the entity received a license to operate the infrastructure.
4. The submitter notes that even though the IASB Board and the Committee have discussed related issues in the past, there is still diversity in practice in determining the appropriate amortisation method for an intangible asset of a SCA. The original submission can be found in Appendix C of this paper.

Objective of this paper

5. The objective of this paper is
- (a) to give an overview of previous discussions at Board or Committee meetings on this subject,
 - (b) to analyse the issue raised, and
 - (c) to recommend the Committee to include an amendment to IAS 38 and IFRIC 12.

Background

6. The table below summarises the previous discussions held by the Board and/or the Committee and their main outcome.

Meeting	Issue	Outcome
<u>Agenda paper (AP 10C)</u> Board meeting December 2006 Annual	May a method of amortisation result in a lower cumulative amortisation than the straight-line	Proposal to change paragraph 98 of IAS 38 to allow the use of the unit of production method and reduce the risk of inappropriate methods of amortisation. IASB Update (December 2006) reported the following:

<p>improvements – Exposure Draft</p>	<p>method?</p>	<p>Paragraph 98 of IAS 38 <i>Intangible Assets</i> states that 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’. The Board has been informed that in practice, ‘rarely, if ever’ is interpreted as ‘never’. The IFRIC project on service concessions highlighted situations in which using the unit of production method of amortisation would be appropriate. However, even when the expected pattern of consumption of the future economic benefits in the asset is weighted to the end of the asset’s life, entities perceive paragraph 98 as restricting them from using this method. As a result, the Board tentatively decided to delete the last sentence of paragraph 98 of IAS 38 to resolve the issue.</p>
<p><u>AP 8B</u> Board meeting March 2008 Comment letter analysis to AIP ED</p>	<p>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</p>	<p>The Board did not specifically discuss the issue raised by constituents during the CL period. The Board confirmed the change to paragraph 98 of IAS 38 in the final AIP 2008.</p>
<p><u>AP 6</u> Committee meeting November 2009</p>	<p>Constituents request guidance on the meaning of ‘consumption of economic benefits’ for an intangible asset with a finite useful life, regarding the:</p> <ul style="list-style-type: none"> • determination of whether useful life should be 	<p><u>Issue of tentative agenda decision:</u></p> <p>The Committee noted that the definition of useful life enables the use of both time-based and units of production-based approaches.</p> <p>The Committee noted that the determination of the amortisation method is a matter of judgement and this judgement should be clearly explained in the notes to the financial statements</p> <p>The Committee concluded that the guidance that it could provide would be in the nature of</p>

	<p>time-based or units of production based; and</p> <ul style="list-style-type: none"> • determination of the rate of amortisation when measuring the useful life using the units of production method. 	application guidance rather than an interpretation.
<p><u>AP 4A</u> Committee meeting January 2010</p>	<p>Analysis of the comment letters received regarding the Committee’s November 2009 tentative agenda decision</p>	<p><u>Issue of final agenda decision:</u></p> <p>The Committee confirmed its tentative decision of November 2009 that the determination of the amortisation is a matter of judgement and significant judgements made should be disclosed in the notes to the financial statements. Any guidance that the Committee would provide would be in the nature of application guidance rather than an interpretation.</p>

The issue

7. The issue raised by the submitter is similar to those raised by constituents during the Board’s and Committee’s discussions in March 2008, November 2009 and January 2010, regarding requests to provide further guidance on the meaning of the phrase ‘consumption of economic benefits’ for an intangible asset with a finite useful life in paragraph 98 of IAS 38.
8. The issue raised by the submitter in this submission focuses more specifically on the clarification of the amortisation methods that are acceptable when applying IFRIC 12’s intangible asset model. We observe that a similar concern had already been raised by one of the constituents who provided comments to the November 2009 tentative agenda decision¹. At the time the staff determined that the

¹ E&Y (letter sent on the 7 December 2009)

respondent's concern about the application of IAS 38 to the accounting for an intangible asset recognised in accordance with IFRIC 12, was another variation or perspective of the fact pattern analysed in the November 2009's submission and the staff did not see a reason to propose a change to the IFRIC's tentative agenda decision on not taking this issue onto its agenda.

9. In this agenda paper we address more specifically the selection of an amortisation method for an intangible asset recognised by an operator under a SCA to the extent that it receives a right (licence) to:
 - (a) operate the infrastructure
 - (b) receive a tariff (the rate chargeable to users of the infrastructure) that increases periodically. This tariff is low at the beginning of the concession period and increases periodically in line with the grantor's practice so as not to burden consumers.

10. The aforementioned analysis will be made in the light of the tentative decisions already expressed by the Board or the Committee at previous meetings.

11. The submitter identified the first two views on selecting an amortisation method. We included a third view which addresses the unit of production method as another amortisation method that constituents have claimed is commonly used in practice.
 - (a) View 1: a revenue-based amortisation method reflects the economic reality of the underlying contractual terms of the SCA. Under this View, the expected pattern of consumption of the expected future economic benefits embodied in the asset is based on the ability of the asset to generate revenue.

 - (b) View 2: a time-based amortisation method reflects the duration of the SCA and as IFRIC 12 is clear that the entity received a license to operate the infrastructure. Under this View, the expected pattern of consumption

of the expected future economic benefits embodied in the asset is based on the consumption of the asset through passage of time.

- (c) View 3: a **unit of production method** is based on an asset's usage, activity, or parts produced instead of the passage of time. Under this View, the expected pattern of consumption of the expected future economic benefits embodied in the asset is based on the use of an asset.

Staff analysis

Methods of amortisation for intangible assets under IFRIC 12

12. A right (licence) of an operator to charge users of the public service meets the definition of an intangible asset (paragraph 17 of IFRIC 12) and should be recognised in accordance with IAS 38 in accordance with paragraph 26.

Paragraph 17 of IFRIC 12 refers that (emphasis added):

The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

13. Paragraph 97 of IAS 38 states that the method of amortisation method used for an intangible asset with a finite life should reflect the pattern in which the future economic benefits embodied in the asset are *expected to be consumed* by the entity [emphasis added]. If that pattern cannot be determined reliably, the entity must use the straight-line method.

14. Paragraph 97 of IAS 38 states that the depreciable amount of an intangible asset with a finite useful shall be allocated on a systematic basis over its *useful life* and amortisation begins when the asset is available for use.
15. Paragraph 8 of IAS 38 defines *useful life* as being either based on:
 - (a) a period over which an asset is expected to be available for use; or
 - (b) on a number of production or similar units expected to be obtained from the asset by the entity.
16. Paragraph 98 of IAS 38 refers that a variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. This paragraph specifically allows, among others, the use of the straight-line method (which is based on the duration of the asset) or the unit of production method (which is based on the use of the asset).
17. Paragraph 98 does not refer specifically to methods of amortisation based on expected future revenues.
18. Paragraphs 97 and 98 of IAS 38 allow an entity to apply its judgement in selecting the amortisation method that better depicts the economic reality of the arrangement and that *better* reflects the pattern of *consumption* of the economic benefits embodied (inherent) in the asset, because after all, amortisation is, by nature, an estimate.
19. In our view different entities will estimate the way in which an asset delivers its benefits in different ways based on the specific characteristics of the intangible assets and the facts and circumstance surrounding its use. The analysis of the case raised by the submitter regarding the choice of a straight line method or a revenue-based approach is discussed in the following section.

Analysis of views - which amortisation methodology best reflects the use of the concession right?

Analysis of view 1- use of a revenue-based amortisation method

20. Proponents of this view interpret the concept of consumption of economic benefits inherent in the license as the generation of economic benefits arising from the asset's use. Consequently, in their view, the generation of future revenues, future profits are appropriate parameters that could be used to reflect the way the asset is used up.
21. Proponents of this view think that the use a revenue-based method is adequate because expected future revenues from the use of the infrastructure are a reliable 'proxy' for the economic benefits embodied in the intangible asset and the pattern in which the benefits are expected to be consumed.
22. The application of this method involves an amortisation formula which uses a ratio of actual revenue to estimated revenue as the amortisation basis. Revenue is derived from an interaction between quantity and price, consequently the application of this amortisation method is considered a 'derived computation' which involves the use of 'units of production' (eg traffic volumes in the case of toll-roads) and toll rates (which provide a return to the toll concessionaires).
23. A revenue-based amortisation method that involves units of production reflects the expiring rights to collect tolls by the realisation of revenue, consequently it represents the expected pattern of consumption of the expected future economic benefits embodied in the intangible asset.
24. This method also gives a more consistent profit margin because it reflects the economics of the overall concession arrangement. Because of the contractual links between the intangible asset and the concession revenue/pricing pattern, proponents of this view think that it is appropriate in a SCA to use a revenue-based amortisation method.

25. Consequently, proponents of this view would agree with the submitter’s conclusions for view 1 that a revenue-based amortisation model better reflects the economic reality of the underlying contractual terms of the SCA.

Analysis of view 2- use of a straight-line amortisation method

26. Proponents of this view observe that in accordance with paragraph 11 of IFRIC 12 the contractual service between the grantor and the operator does not give the operator the right to control the use of the infrastructure as follows (emphasis added):

Infrastructure within the scope of this Interpretation shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

27. If the contractual agreement only gives the operator the right of use (and consequently, does not recognise an item of property plant and equipment), proponents of this view think that is valid to infer that the amortisation method for SCA should be focused on the use of the contractual right more than on the use of the underlying tangible asset (in this case, the toll-road or infrastructure).
28. Consequently, proponents of this view would conclude that the economic benefits associated with the license do not arise out of the use of the infrastructure (ie the toll- road) and hence from the revenue generated from the traffic flow (as we mentioned before, revenue is a function of traffic volume and price), as View 1 supports. Instead, the focus appears to be on the right itself to operate the infrastructure for a certain period in line with View 2. The right to operate for a

specified period of time is expected to be ‘consumed’ through the passage of time and consequently, a straight-line method of amortisation is more appropriate.

Analysis of view 3- unit of production method based on production/usage volumes

29. Proponents of this view observe that the economic benefits of an asset in a SCA are its ability to be used to provide the public service which is the focus of the SCA.
30. The operator does not control the underlying asset and recognises an intangible asset to the extent that it receives a right (license) to charge users of the public service. In some cases, the operator must return the underlying asset to the grantor in a wearable/useable condition. Consequently, the physical wearing out of the underlying assets is relevant to the operation of the SCA even if an intangible asset, rather than the physical assets are recognised in the statement of financial position. A volume-based method reflects this wearing out better than a time-based method.
31. Further, the wearing out of the underlying asset is not affected by the revenue generated by each unit produced/used. For example, each car on a toll road has the same impact on the wearing out of the road, whatever fee is charged for the car to travel on the road. A car charged CU12 does not wear out the road four times as much as one that is charged CU3. The price charged is irrelevant when assessing the consumption of benefits of the underlying assets.
32. Consequently, proponents of this view would support a units of production method because it better reflects the pattern of consumption of the economic benefits embodied in the intangible asset recognised under the contractual terms of the SCA.

Our view

33. We disagree with View 1 in the submission. We note that paragraph 97 of IAS 38 is clear that the amortisation method should ‘reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity’ (emphasis added) and the focus should not be on the generation of economic benefits such as revenue.
34. We also think that revenue is not necessarily a feature of the intangible asset being amortised because revenue:
- (a) is not necessarily a measure of the results of using an intangible asset in isolation but might incorporate the use of other assets, people and processes; and
 - (b) is only a factor associated with the environment in which the asset is used².
35. Said differently, revenue from the use of an asset does not necessarily reflect the pattern of consumption of the benefits inherent in the intangible asset itself. To illustrate our view, consider an extreme case in which an entity has an exclusive license to distribute product B but decides to wait for its distribution until it achieves maximum sales from another product that belongs to an old line (ie Product A); therefore it decides to postpone the amortisation of the license for product B until further notice. Clearly, the right to distribute product B can be exercised irrespective of the outcome for product A and amortisation could commence regardless of the entity’s decisions to delay the distribution of product B.
36. We have found evidence that a revenue-based approach is used only in limited cases for assets that generate revenues directly and independently from other assets. This is the case for example of film rights for some entities in the

² A similar conclusion was drawn by the Hong Kong Institute of Certified Public Accountants in its response to the November 2009 IFRIC’s tentative agenda decision (refer to Agenda paper 4A).

entertainment industry (which are considered part of their inventory) that are amortised in the proportion that revenue in the year bears to the estimated ultimate revenue, after provision for any anticipated shortfall.

37. Based on our observations in the paragraphs regarding the use of the revenue-based method we do not think that this is an appropriate approach for amortising intangibles under SCA.
38. On the other hand, we do not disagree with the conclusions drawn for View 2 that a straight line-method could be used for amortising the license to operate the infrastructure. We also support the view that this methodology could be used as a default methodology when an entity is unable to reflect reliably the pattern in which the future economic benefits of the intangible asset are expected to be consumed. But we do not think this is the only methodology that could be used.
39. As pointed out by some constituents in their replies to IFRIC’s tentative agenda decisions in past years (refer to the table in paragraph 6 above), management has determined in some occasions that the pattern of consumption of the benefits associated with toll-road operation rights is driven mainly by traffic volumes leading to usage-based approach (that could be considered a variation of the unit-of- production method), and have concluded that this method better reflects the economic reality of the arrangement between the operator and the grantor, because this method will normally result in a lower initial amortisation in the earlier years of the asset’s life (as opposed to the amortisation charge derived from a straight-line method that will be constant during the concession life). Also, as discussed above, a unit of production method better reflects the use of the underlying asset of a concession arrangement than an approach based on the passage of time.
40. Whilst we still think that the selection of an amortisation method is subject to judgement, we think that a unit of production method is more appropriate to reflect the economic reality of a SCA and the reasons for the choice of an

amortisation method should be adequately explained and disclosed in the notes to the financial statements.

Staff recommendation

41. We observe that in the past there has been some reluctance to clarify the use and selection of amortisation methods in IAS 38 as the application of paragraphs 97 and 98 involve the use of professional judgement. However, we think that some application guidance could be provided to assist with the exercise of that judgement. In addition, we think that revenue-based amortisation methods should not be allowed because their emphasis is on the generation of expected economic benefits rather than on the consumption of economic benefits. We think that this clarification could be made in IFRIC 12 as the submission analysed in this paper and past submissions have given us evidence that this method has been used when accounting service concession arrangements. Consequently we propose the following amendments:

- (a) clarify the meaning of ‘consumption of the expected future economic benefits’ by adding application guidance to IAS 38; and
- (b) add a clarification below paragraph 26 in IFRIC 12 that methods based on the ‘generation of expected future benefits’ are not appropriate.

Clarify the meaning of ‘consumption of the expected future economic benefits’ by adding application guidance to IAS 38.

42. Given the above analysis and in response to the submitter’s request, we have detected a need to clarify the meaning of the term ‘consumption of the expected future economic benefits embodied in the asset’ when determining the appropriate amortisation method for intangible assets in IAS 38. Consequently, we propose adding to this Standard a couple of illustrative examples that could illustrate

different patterns of consumption of the economic benefits inherent in an asset that could be taken into consideration when choosing an amortisation method. These examples could be included as part of the Illustrative Examples section in IAS 38. We thought about including them below paragraph 98 as ‘Examples illustrating paragraph 98’, however we do not think examples should be part of the Standard. Our proposals to add application guidance regarding the application of paragraph 98 of IAS 38 are shown in **Appendix A** of this paper

Clarify that methods based on the generation of benefits are not appropriate

- 43. We also think that paragraph 26 of IFRIC 12 could be more specific about the fact that that methods based on the generation of expected future economic benefits (as opposed to the consumption of benefits) arising from the asset’s use are not appropriate for service concession arrangements. This paragraph could also mention methods of amortisation that are appropriate for service concession arrangements in the same way as paragraph 98 in IAS 38 does.
- 44. Our proposals to amend paragraph 26 of IFRIC 12 are shown in **Appendix B** of this paper.

Annual improvements criteria assessment

45. In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against certain criteria. All the criteria (a)-(d) must be met to qualify for inclusion in annual improvements. We have assessed the proposed amendment against the enhanced annual improvements criteria, which are reproduced in full below:

Annual improvements criteria	Staff assessment of the proposed amendment
(a) The proposed amendment has one or both	(a) Yes. The proposed amendments clarify:

<p>of the following characteristics:</p> <p>(i) clarifying—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. <p>A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.</p> <p>(ii) correcting—the proposed amendment would improve IFRSs by:</p> <ul style="list-style-type: none"> • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs. <p>A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.</p>	<ul style="list-style-type: none"> - the application of paragraph 98 of IAS 38 for choosing an amortisation method; and - the interrelationship between IAS 38 and IFRIC 12 in the selection of an appropriate amortisation method for intangible assets that are recognised in accordance with IFRIC 12.
<p>(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.</p>	<p>(b) Yes. We believe that the proposed amendments are well defined and are sufficiently narrow in scope such that the consequences of the proposed change have been considered. It contributes to consistent accounting for choosing an amortisation method for intangible assets under SCA.</p>
<p>(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.</p>	<p>(c) Yes. We think that the IASB will reach a conclusion on this issue on a timely basis, because it is a clarification on how IAS 38 and IFRIC link in terms of choosing amortisation methods.</p>
<p>(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project</p>	<p>(d) Yes because there are no current projects on IAS 38 or IFRIC 12.</p>

would.	
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Agenda criteria assessment

46. 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 submission indicate, there are divergent interpretations.
- (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 conclusion

47. Given the above analysis and the annual improvements criteria assessment, we recommend that the Committee should suggest to the Board to add application guidance regarding the application of paragraph 98 of IAS 38 and the Committee could amend paragraph 26 of IFRIC 12, as shown in **Appendix A and Appendix B** of this paper, respectively.

Question for the Committee – amortisation of service concession arrangements

1. Does the Committee agree with the staff recommendation in paragraph 47 above about adding application guidance regarding the application of paragraph 98 of IAS 38 and clarifying paragraph 26 of IFRIC 12?
2. Does the Committee have any comments on the proposed changes shown in Appendices A and B?

Appendix A – Proposed changes (IAS 38)

- A1. We propose adding two examples to illustrate the application of paragraph 98 of IAS 38, as follows:

Amendment to IAS 38 *Intangible Assets*

The following examples are added to the ‘Illustrative examples’ section of IAS 38.

IAS 38 *Intangible Assets* Illustrative examples

These examples accompany, but are not part of IAS 38

Selection of amortisation methods

The following guidance provides examples when selecting amortisation methods on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset in accordance with paragraphs 97 and 98 in IAS 38.

Each of the following examples describes an acquired intangible asset and the reasons why a certain amortisation method would be more appropriate.

Example 1: An acquired license to operate telephone services

Entity A has recognised an intangible asset in respect to a license acquired to operate telephone services in a specific area for 10 years.

Which amortisation method would be more appropriate?

The operation of this licence is unrelated to the number of telephone lines, to the number potential customers subscribed to these services, or to the sale of telephone services. Consequently, a straight line method is likely to be more appropriate because the benefits embodied in the licence are expected to be consumed through the passage of time.

Example 2: An acquired right to exploit oil and gas resources

Entity A has engaged in the exploration of oil and gas resources and has recognised an intangible asset to recognise its right to extract crude from an oil field in a period of 15 years.

Which amortisation method would be more appropriate?

Entity's A right to extract crude is unrelated to the passage of time because the reserve might be depleted before the extraction right ends (said differently, the productive capacity inherent in the asset is finite). It is also not directly related to the future oil price³. Consequently, a units of production method is likely to be more appropriate because the pattern of consumption of the economic benefits embodied in the extraction rights to extract crude oil is directly related to the amount of oil resources in the field reserve.

Amendment to the Basis for conclusions of IAS 38 *Intangible Assets*

Basis for Conclusions on proposed amendments to IAS 38 *Intangible Assets*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Selection of amortisation methods

- BC1 The Board received a request to clarify the meaning of the term 'consumption of the expected future economic benefits embodied in the asset' of an intangible asset with a finite useful life when determining the appropriate amortisation method for intangible assets in accordance with paragraphs 97 and 98 in IAS 38. This issue was raised in the context of the application of IAS 38 to the intangible assets of operators recognised in accordance with IFRIC 12 *Service Concession Arrangements*. The Board proposes adding application guidance that could assist to the exercise of judgement when selecting amortisation methods. The Board also proposes adding a clarification in IFRIC 12 that amortisation

³ Although oil price will influence how much crude oil is recovered –the higher the oil price the higher the marginal cost of oil production can be towards the end of the licence term and if it would still be profitable to produce. It is not a direct determinant of the volume of oil that will be produced.

methods based on the ‘generation of expected future benefits’ are not appropriate for service concession arrangements.

Appendix B –Proposed changes (IFRIC 12)

B1 The proposed amendment to IFRIC 12 is presented below.

Amendment to IFRIC 12 *Service Concession Arrangements*

Paragraph 26A is added. Paragraph 26 is not proposed for amendment but is included here for ease of reference

Intangible asset

- 26 IAS 38 applies to the intangible asset recognised in accordance with paragraphs 17 and 18. Paragraphs 45–47 of IAS 38 provide guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets
- 26A Paragraph 98 of IAS 38 provides for a number of amortisation methods for intangible assets with finite useful lives. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits. Methods selected on the basis of the expected pattern of generation of the expected future economic benefits embodied in the asset (as opposed to the consumption of those benefits), such as the generation of future revenues or future profits are not appropriate for intangible assets recognised under paragraph 26.

Basis for Conclusions on proposed amendments to IFRIC 12 *Service Concession Arrangements*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Intangible asset

- BC1 The Interpretation requires the operator to account for its intangible asset in accordance with IAS 38. Among other requirements, paragraphs 97 and 98 of IAS 38 require the selection of an amortisation method on the

basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset. Paragraph 97 states that ‘the amortisation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity.’

- BC2 The Committee considered whether it would be appropriate for intangible assets under paragraph 26 to be amortised using a revenue-based amortisation method (ie one that takes account of the actual revenue to estimated revenue as the amortisation basis and that is derived from an interaction between quantity and price –traffic volumes and toll rates) in the context of a service concession arrangement where (a) the rate chargeable to users is contracted in the agreement and (b) a lower tariff is imposed at the beginning of the concession and increases periodically in line with the grantor’s practice so as not to burden consumers. The Committee proposes that a revenue-based approach places emphasis in the generation of expected economic benefits rather than in the consumption or use of the asset’s future economic benefits. In addition, the Committee did not identify any unique about intangible assets recognised under service concession agreements that would justify use of a method of amortisation different from that used for other intangible assets.

Appendix C – Request for Annual Improvements

C1 The staff received the following request from the Malaysian Accounting Standards Board (MASB). All information has been copied without modification.

10th October 2011

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Wayne,

Request for IFRIC Agenda Item – Clarification on the application of Amortisation Method in IAS 38 *INTANGIBLE ASSETS*

To date, we have put in place most of the IFRSs, including the IFRIC Interpretations.

Currently one of the remaining issues in Malaysia is whether the interpretation related to IFRIC 12, on the meaning of ‘consumption of economic benefits’ when determining the appropriate amortisation method for an intangible asset with a finite useful life, is clear.

The issue relates to the application of IAS 38 Intangible Assets on the intangible assets of operators, which are within the scope of IFRIC 12 Service Concession Arrangement.

We understand that the IFRIC had in its November 2009 and January 2010 discussed the request for guidance in the determination of amortization method. In those meetings, the IFRIC noted that the determination of the amortisation method is a matter of judgement and given the diversity of views, IFRIC concluded it would not be able to reach a consensus on the issue within a timely basis.

Hence, the request was not added to the IFRIC's agenda though we noted some members of the IFRIC believed that an interpretation could assist in reducing diversity in the implementation of the amortisation principle prescribed in IAS 38.

The Issue

We would like to express our concern that divergence in interpreting IAS 38 continues to exist for intangible assets of operators within the scope of IFRIC 12.

Specifically, we believe better guidance is required in determining the amortisation method for intangible asset of service concession arrangements (SCA) where:

- (1) the rate chargeable to users (hereinafter referred to as tariff) is contracted in the agreement; and
- (2) a lower tariff is imposed at the beginning of the concession period and increases periodically to be in line with the grantor's practice so as not to burden consumers at large (and in all instances, if the operator is denied of a higher tariff, the grantor will have to compensate for the shortfall).

As a result of the lower tariff in initial years, the future increases in tariffs will include the cost of recovery of the capital invested. This particular arrangement is rather different from other types of SCA where the tariff at the beginning of the concession period has to an extent already included full cost recovery.

The Differing Views

In such an arrangement there is divergent treatment by operators in accounting for the amortisation of the intangible asset:

View 1: a revenue-based amortisation method better reflects the economic reality of the underlying contractual terms of the SCA.

View 2: a time based amortisation method, i.e. straight line method, is most appropriate as it reflects the duration of the SCA and IFRIC 12 is clear that the entity received a license to operate the infrastructure.

The conceptual argument and rationale of View 1 and View 2 are attached in Appendix 1 and Appendix 2 respectively for your consideration.

We believe the debate between View 1 and View 2, is based on how the phrase "The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity" in paragraph 97 of IAS 38, is interpreted.

The debate has further intensified in recent months as we are proposing for entities to also assert compliance with IFRS Framework in their financial statements come 2012 when we fully converged with IFRS. In view of this, there are concerns in our market whether it is appropriate for those who subscribed to View 1 to continue using the revenue-based method of amortisation for the intangible asset of a SCA that contains the above fact patterns. Equally, others feel no concern about this as in their view the amortisation method reflects the pattern in which the intangible asset's future economic benefits are expected to be consumed by the entity.

We are therefore writing to request the IFRS Interpretations Committee to provide more clarification to address this pressing and urgent issue to ensure the meaning of "consumption of economic benefits" is interpreted consistently by IFRS users.

We believe the issue is relevant to all operators of service concession arrangements, not only in Malaysia, but also in other jurisdictions.

If you need further clarification or information, please contact Ms Tan Bee Leng at +603 2240 9200 or by email at beeleng@masb.org.my.

Thank you.

Yours sincerely

MOHAMMAD FAIZ AZMI

Chairman

Appendix 1

View 1:

A revenue-based amortisation method better reflects the economic reality of the underlying contractual terms of the SCA.

Rationale of View 1

- (i) View 1 believes it is inapt to generalise all SCA by analogy and conclude that revenue-based amortisation is not appropriate.

In most types of SCA there is no legal right to different contractual tariff. However, a SCA that gives the operator:

- (1) the right to operate the infrastructure and charge users and
- (2) the right to higher tariff in future adds value to the SCA and should be considered as one of the factors in determining the amortisation method of the intangible asset.

In particular, the second contractual right (and clearly an entity will have to pay for such a right) is an important feature/benefit that should not be ignored. Therefore an intangible asset of such a SCA should merit a different amortisation method from intangible assets of other types of SCA as they are economically dissimilar.

- (ii) View 1 further believes that using the straight line method is an easy way out without practically exhausting other alternatives and does not provide a fairer presentation of the financial performance as well as financial position of the entity.

For example if there are two agreements in a SCA, whereby the contracted tariff for the first agreement for Year 1 to Year 5 is x rate and the contracted tariff for the second agreement for Year 6 to Year 10 is $x+y$ rate, the fair value of the intangible assets of these two agreements will be different.

In such a SCA, the amortisation of the intangible assets will be based on the fact pattern of the respective agreements and will not be bundled as a single

agreement for the purpose of amortisation on a straight line basis – hence the amount to be amortised in Year 1 to Year 5 and Year 6 to Year 10 will obviously be different as well.

It therefore follows in a 10-year SCA with identical fact patterns, ignoring tariff increases in the amortisation of the intangible asset will not faithfully reflect the pattern in which the future economic benefits of the intangible asset are expected to be consumed.

- (iii) Consequently View 1 believes it is not unreasonable to conclude that the fair value of such intangible asset is directly related to the future economic benefits of the asset, whereby to arrive at the fair value of the intangible asset key factors that will be taken into consideration are concession period, volume, contractual tariff and discount rate.

As these factors are the key determinants of the fair value of the intangible asset, it is not unreasonable to also conclude that the future economic benefits of the asset is linked to the contractual tariff and not just linked to the concession period.

In other words, the value of such a SCA intangible asset is the sum of many parts that have been agreed between the grantor and the entity. If the benefits of those parts have not flowed to the entity since the future promised increase in tariff has not been implemented, the entity should not amortise the cost ascribed to that part of the intangible asset related to a future tariff.

View 1 noted this analysis is consistent with IAS 38 paragraph 17 which explicitly clarifies future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity.

- (iv) ‘interest’ method of amortisation ≠ revenue-based method of amortisation

View 1 also believes there is a distinct difference between ‘interest’ method and revenue-based method of amortisation. Assuming a constant cash inflow streams, the former will require a higher amortisation of the intangible asset in initial years and a smaller amortisation towards the end of its useful life, similar to the amortisation of a bond.

On the other hand the revenue-based method of amortisation attempts to spread the recovery of the intangible asset by looking only at the future returns. Using the same example above, i.e. a constant cash inflow streams, the amortisation of the intangible asset will be equal throughout its useful life.

Therefore the amortisation patterns of the 'interest' method and the revenue-based method of amortisation should not be considered the same or even similar.

Appendix 2

View 2:

A time based amortisation method, i.e. straight line, is most appropriate as it reflects the duration of the service concession arrangement (SCA) as IFRIC 12 *Service Concession Arrangements* is clear that the entity received a license to operate the infrastructure.

Rationale of View 2

- (i) View 2 believes revenue realised or realisable constitutes the compensation for the provision of services and that the expected pattern of such realisation may not necessarily equal to the expected pattern of consumption of the future economic benefits embodied in the intangible asset.
- (ii) Although View 2 acknowledges that the valuation of such an intangible asset is related to the contracted tariff, revenue-based amortisation method is not appropriate because it may not reflect the pattern in which the intangible asset's future economic benefits are expected to be consumed.

In addition it is irrelevant whether one intangible asset is worth more than another in the selection of amortisation method for the cost incurred in acquiring or developing the intangible asset.

- (iii) View 2 also believes consumption of economic benefits refers to using up of the ability to generate revenue, i.e. wear and tear or equivalent of an asset through it generating revenue, and is not the same as realisation and amortisation of economic benefits (which relates to its ability to generate revenue and how to amortise the revenue).

Thus, while an asset generates revenue, it is used up (or consumed) through wear and tear or passage of time. However, it cannot be used up through the revenue it generates as revenue is affected by unit pricing which is not related to consumption.

View 2 further noted that the contracted tariff may contain factors that compensate future variables, for example, inflation. Incidentally, they believe future revenue in absolute terms takes into account the time value of money and hence revenue-based amortisation method is essentially an 'interest' method of amortisation which the IFRIC noted is not permitted under IAS 38 as clarified in paragraph BC65 of IFRIC 12.