

MFRS Hot Topics

Methods of amortising intangible assets

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue provides guidance on selecting an appropriate amortisation method for intangible assets in accordance with MFRS 138 Intangible Assets.



MFRS 138 requires that an entity shall choose either the cost model or the revaluation model as its accounting policy. In practice, it is likely that the cost model will be generally preferred by most entities.

Under the cost model, after initial recognition, an intangible asset shall be carried at cost less accumulated amortisation and accumulated impairment loss, if any.

This issue provides guidance on selecting an appropriate amortisation method for intangible assets in accordance with MFRS 138 with particular reference to:

- the straight-line method
- unit of production method
- revenue-based methods.

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Introduction

MFRS 138.97 requires 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. A variety of amortisation methods can be applied. MFRS 138.98 mentions the *straight-line method*, the *diminishing balance method* and the *unit of production method*.

Methods of amortisation based on expected future revenues (revenue-based methods) are not mentioned. However, we consider that a revenue-based method is appropriate in limited cases when expected future revenues are a reliable 'proxy' for the economic benefits embodied in the asset and the pattern in which the benefits are expected to be consumed.

Although MFRS 138 envisages the use of various different methods, it requires the straight-line method if the pattern of consumption of future economic benefits cannot be determined reliably (MFRS 138.97)



Selecting an appropriate amortisation method

The amortisation method selected by the entity should reflect the pattern of consumption of the economic benefits embodied in the intangible asset. Selecting an appropriate amortisation method is a matter of professional judgment based on the specific characteristics of the asset and the facts and circumstances surrounding its use or exploitation.

Straight-line method

The straight-line method will be appropriate where the consumption of economic benefits is based on the passage of time, for example patents and licenses granted for a finite period of time. In addition, the straight-line method is the default method where the pattern in which the asset's future economic benefits are expected to be consumed cannot be determined reliably.

Unit of production method

The unit of production method is likely to be more appropriate for intangible assets associated with depleting resources, for example rights to extract oil and gas resources, where the benefits embodied in the asset relate directly to the resources consumed.

Revenue-based methods

There may also be circumstances where a method of amortisation based on the pattern of expected future revenues could be used (revenue-based method). Revenue-based methods are appropriate only when expected future revenues are a reliable 'proxy' for the economic benefits embodied in the asset and the pattern in which the benefits are consumed. This will apply only in limited cases. This is partly because revenues are a measure of the results of using an asset (usually along with other assets, people and processes) rather than a measure of the economic benefits embodied within the asset. Revenue based methods are more likely to be suitable for assets that are licensed or otherwise generate revenues directly and reasonably independently of other assets.

Revenue-based methods determine the amortisation charge from expected revenues. As noted, revenues result from using an asset and do not necessarily reflect the consumption of the benefits inherent in the intangible asset itself. For example, consider an entity that has a five-year exclusive license to distribute a product. In the first year the entity decides not to distribute the product because it wants to achieve maximum sales from a previous generation product. In this case, the license represents a single right to distribute the product for a finite time period and it is appropriate to amortise the licence in the first year because the product could have been distributed, ie the benefits inherent in the license were available and have diminished by a fifth regardless of the actions of the entity. This is consistent with the requirement in MFRS 138.97 for amortisation to commence when the intangible asset is available for use.

The relevance of 'expected to be consumed' in MFRS 138.97 is that amortisation should be charged according to the pattern of consumption of economic benefits that the entity envisages at the outset rather than being related to the actual revenues achieved. For example, if 20% of revenues are normally expected in the first month after a film's cinema release, 20% of the amortisation is charged in the first month. The same amount of amortisation is charged even if actual revenues are disappointing as this percentage still reflects the proportionate consumption of the economic benefits embodied in the asset. (Such a situation may of course also give rise to impairment issues to be accounted for in accordance with MFRS 136 Impairment of Assets.) Similarly, if the revenues are higher than anticipated, this does not justify charging more amortisation.

The expected pattern of consumption of the economic benefits embodied in the asset is considered each period in a similar way to the reconsideration of the depreciation method applied to property, plant and equipment in MFRS 116 Property, Plant and Equipment.

Applications of the methods discussed

Example 1 - Telecommunications provider

Entity A has recognised an intangible asset at cost in respect of licenses acquired to provide telephone services. The licenses permit entity A to operate services in a specific geographical area for a finite time period. The price paid was not dependent on the number of potential customers but represented the best offer that fulfilled the technical specifications in a competitive tender process. The licenses relate to a geographical area where Entity A has no previous experience and its forecasts will be subject to a degree of uncertainty.

*What is the most appropriate amortisation method for the **TELEPHONE LICENSES** intangible asset?*

Analysis

The costs of the telephone licenses should be amortised on a straight line basis over the specified license period. The economic benefits embodied in the license are expected to be consumed based on the passage of time. The price paid for the license was based on the geographic area and time period. The unit of production method would not be appropriate as production is not related to the pattern of consumption of the economic benefits embodied in the license. The license does not refer to the number of items produced (ie telephone lines). A revenue based method would not be appropriate as the sale of telephone services is not related to the pattern of consumption of the economic benefits embodied in the license. Finally, Entity A is unable to forecast demand or production reliably due to its lack of previous experience in the geographical area specified in the license. Therefore, the straight line method should be used in accordance with MFRS 138.

Example 2 - Oil and gas industry

Entity B is engaged in the exploration and development of oil and gas resources. B has recognised an intangible asset acquired in a business combination at fair value in respect of its share of the rights to extract crude oil from oilfield XYZ for a period of twenty years. The fair value of the acquired rights reflects B's share of the expected production of oil from field XYZ over the twenty year period.

*What is the most appropriate amortisation method for the **EXTRACTIVE RIGHTS** intangible asset?*

Analysis

The carrying amount of the extraction rights should be amortised using the units of production method. The production basis reflects the pattern of consumption of the economic benefits embodied in the extraction rights (quantities of oil included in reserves of field XYZ) and is therefore the most appropriate method. The total share of production used for amortisation of the rights will be that expected over the twenty year term of the rights. Amortisation in each period will be calculated as the ratio of B's share of production in the period to B's share of production over the remaining term of the rights at the end of the period plus B's share of production in the period. A straight line method of amortisation would not be appropriate as the pattern of consumption of the economic benefits embodied in the extraction rights is not based on the passage of time. A revenue based method of consumption would not be appropriate as the future oil price is unrelated to the pattern of consumption of the economic benefits embodied in the extraction rights.

Example 3 - Film industry

Entity C produces and distributes films for both the domestic and international markets. C retains commercial ownership of the intellectual property rights relating to each film. C has recognised an intangible asset in relation to the rights to films, which it has produced or acquired. Based on past experience C estimates that box office receipts from cinema release of a film will account for 15% of total expected revenues. Sales of DVDs and videos and licensing of TV broadcasting rights are expected to account for a further 45% and 35% of total revenues respectively. Licensing of other ancillary film rights is expected to account for the remaining 5% of total revenues. A film is estimated to have a life cycle of three years from the date of its first release.

*What is the most appropriate amortisation method for the **FILM RIGHTS** intangible asset?*

Analysis

The expected future revenues from the film rights intangible asset serve as a reliable 'proxy' for the economic benefits embodied in the film rights intangible asset and the pattern in which the benefits from the intangible asset are expected to be consumed. In this case, the film rights intangible asset represents several different rights (cinema, DVD, video, TV and ancillary rights), which are sold at different times. The carrying amount of the film rights should be amortised over the discrete phases of the film's life cycle using a revenue basis as this best approximates the consumption of the economic benefits embodied in the asset. The rights will be amortised 15% on cinema release, 45% on DVD and video release, 35% on licensing of TV broadcasting rights and 5% on licensing of ancillary rights.





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