

ISSUES PAPER FOR THE AEG JULY 2005 – SNA UPDATE ISSUE 11

FOLLOW-UP TO ORIGINALS AND COPIES

THE TREATMENT OF ANNUAL LICENSES-TO-USE

Nadim Ahmad, OECD

Introduction

1. An issues paper on originals and copies was discussed by the AEG in its December 2004 meeting. The AEG were happy with the recommendations made by the Canberra II Group, but there was some disagreement on the treatment of regular (annual) payments for licences to use copies, with particular reference to software. The AEG asked the Group to further consider this point. The Canberra II Group has done this and this document spells out its views.

Background

2. To recap, the proposals made in the Issues paper and repeated below, were identical to those made by the OECD Software Task Force in 2002. With respect to annual payments for licences to use software, two specific cases were considered by the Software Task Force:

(I) Sequence of annual payments (an initial payment followed by smaller “maintenance” updates)

These transactions should be interpreted as purchases of software copies in the first year and purchases of updates (improvements to the first version) in subsequent years. Making an initial payment for acquisition of the software, followed by a series of smaller “maintenance license” payments in subsequent years, is little different in practice from making one up-front payment for the software reproduction, and so the treatment should be, in practice, the same.

(II) Sequences of regular (equal) annual payments

One particular and important type of transaction is when regular payments for a license-to-use are made annually. If the purchaser intends to use the software repeatedly in production until the end of its economic life then the treatment should follow that for a sequence of annual payments set out in (I) above. The full value of the software reproduction should be recorded as fixed capital formation in the first year of the acquisition of the software, with annual license payments corresponding to interest payments thereafter, following the usual national accounts rules for financial leases. Where this is not practical it is acceptable to capitalise the annual license payments as and when they occur.

3. The AEG were happy with the recommendation on Type (I) transactions but were uncomfortable with the recommendation proposed for Type (II) transactions. The concern of the AEG was not that the payments were annual; it was about the length of the licence. If the licence was for many years they were happy. But if the licence was for only one year they were not. This may be because the issues paper provided to the AEG did not contain a detailed explanation as to why the Software Task Force arrived at this view; it merely contained a summarised recommendation.

Software Task Force Reasoning

4. The Task Force considered this specific case because of the existence of a number of software products on the market that could only be purchased with annual licenses. SAS was given as the main example. The Task Force had already accepted that copies purchased with an up-front one-off payment should be treated as fixed capital formation (as has the AEG). It appeared inconsistent therefore that purchases of SPSS say, where it was possible to make one-off payments, were fixed capital formation but those of SAS say were not, merely because SAS only sold their products using annual licenses. This was despite the fact that many purchasers of SAS products would have had the intention of using the software until the end of its working life.

5. Moreover it appeared that this intention was likely to reflect the majority of cases, because, when companies purchase software products such as SAS, a number of other significant costs are incurred that point to continued use beyond one year. The acquisition of software by a company involves significant other start-up costs such as training and the costs of developing operating systems, databases, software programs etc based on the new software, and it seemed unlikely that companies would undertake, or be willing to undertake, these additional costs every year. It seemed sensible therefore to draw on the analogy of operating and finance leases to support the capitalisation of expenditures on software which the purchaser intended to use for more than one year (and, in the case of software, it is often the case that purchasers continue to pay annual payments right up to the end of the working life of the software). The Software Task Force concluded, therefore, that the fact payments have to be made every year largely reflects contractual obligations and not the *intent* of the institution, and that, where the intent could be established, the payments should be treated in accordance with the accounting rules of finance leases.

Counter-Arguments

6. The counter-arguments to the Software Task Force's view centre on choice.

7. The first of these contends that where restrictive modes of payment occur, (for example SAS annual payments), an institution with a real intention to use the copy (software) for more than one year could demonstrate this by choosing to negotiate directly with the software publisher/producer and purchase the software up-front.

8. But this argument pre-supposes that the software provider would be willing to change its terms. For sake of argument, let's assume that it is, it's quite plausible that some large institutions might be able to negotiate these terms but it's not obvious that all large institutions would be able to and very unlikely that small and medium institutions could. In fact it's debatable whether the thought would necessarily occur to some large institutions to negotiate these terms (unless possibly there was some other obvious, usually financial (e.g. tax) benefit to be derived) or, perhaps, some risk that the software provider say would raise prices to exorbitant levels in the future or decide, for no obvious reason, to pull it's product off the shelf. Most purchasers take the view that these risks are slight and so invest heavily in training and create systems and add-ons based on their annually acquired software.

9. The second argument against the Software Task Force recommendation is also a question of choice. If the purchasers of SAS really intended to use the asset for more than one year they would have purchased an equivalent product that they were able to own for more than one year, for example, SPSS.

10. This is rarely how these decisions are made however. For a start it assumes that an identical product exists on the market that can be purchased with one payment. Secondly, software procurement decisions take in a number of factors: What system is used by our customers/stake-holders/rest-of-the-organisation? Which software is most compatible with our other software systems? How much do they

cost, bearing in mind that we intend to use them for the same period of time? But do we intend to use them for more than one year? How much will training cost? Is one system easier to use than the other? Somewhere amongst these questions might be: Will they let us purchase the software with a one-off upfront payment be? But it's not clear that it will be first on the list.

11. That is not to say that the choice argument does not have some merit. Clearly it's neater to treat all copies purchased in this way as intermediate consumption. But is this the correct approach?

12. Another criticism of the counter-argument is that, by extension, it pretty much does away with finance leasing. For example, in principle any institution that makes annual payments for a plane say could instead have purchased the same plane up-front. As such, the counter-arguments to the Software Task Force recommendation suggest that the annual payments are never treated as finance leases.

The Software Task Force recommendation is consistent with the SNA

13. A re-read of paragraph 5 above reveals that, in substance, all the Software Task Force recommendation calls for is to treat annual payments as financial leases where relevant. Paragraph 6.118 of the SNA says *Financial leases may be distinguished by the fact that all the risks and rewards of ownership are, de facto, transferred from the legal owner of the good, the lessor, to the user of the good, the lessee.*

14. The Software Task Force's opinion was that these risks (up-front costs in training etc) and rewards were passed to the software purchaser. If these conditions could not be satisfied (intention could not be established) then the costs should not be treated as fixed capital formation. The view of the Software Task Force therefore was that its recommendation on annual licences for software was completely consistent with the SNA.

Different views reflect different meanings of 'intention'

15. In fact one might say that the only difference between the Software Task Force view and those who disagree with its recommendation is that the benchmark for 'intention' is different; higher for those who disagree.

16. For those who disagree, this intention can only be demonstrated by doing, i.e. acquiring a longer licence. For those in favour, the intention is demonstrated by the significant up-front costs, and the knowledge, that in many, arguably most, cases, it truly is the intention of the institution to use the software for more than one year.

17. Partly for pragmatic reasons, partly because it was their widely held view, and partly because they were concerned with improved cross-country harmonisation, the Software Task Force also stated that it was likely that in most cases the 'intention' to use for more than one year held. It seems that it is the attempt to provide some (almost quantitative) guidance (nearly 100% of cases) on the benchmark for intent that has caused the AEG to pass this issue back to the Canberra II Group. Removing this guidance would probably neutralise these concerns, since, as shown above, the Software Task Force recommendation merely calls for transactions to be recorded as finance leases where they satisfy the SNA rules. However, it could come at a cost of reduced harmonisation.

18. Moreover the same criticisms could be made of the counter-arguments. Since these, in effect, state that 0% of cases satisfies the benchmark for intent, and that none of the transactions should be treated as finance leases.

The benchmark for ‘intention’ differs according to the asset type

19. Although in principle the recommendation made by the Software Task Force applies to all types of copies (e.g. books), in practice, the impact on these other asset types will be much smaller. For software one of the key characteristics of ‘intention’ was the significant up-front costs. This is not likely to feature as a common characteristic in other types of copies, and so in most cases these costs will be treated as intermediate consumption.

20. In principle, when an asset is acquired it should be recorded at its full value. In the case of the acquisition of a licence to use which is renewable annually, it would be in the spirit of the 1993 SNA to record capital formation, at the time of acquisition, as the expected net present value of future annual licence payments. Where this is not practicable, an acceptable alternative would be to record the annual licence payments as capital formation in the year they occur and consumption of fixed capital in the same year.

Recommendations

21. With this fuller explanation in place, the AEG is asked to support the recommendations of the Software Task Force that

(a) If a copy (license-to-use) is acquired via regular annual payments, the payments should be recorded as finance lease transactions if it can be established that the purchaser intends to use the copy repeatedly in production until the end of its economic life. Intent can be determined if significant associated costs are incurred on acquisition. For example, for software, the costs involved in training or developing new systems based on the software. For other copies however establishing intent is likely to be less common.

(b) The full value of the software reproduction should be recorded as fixed capital formation at the time of acquisition, with annual license payments corresponding to interest payments thereafter, following the usual national accounts rules for financial leases. When this is not practical it is acceptable to capitalise the annual licence payments as and when they occur and CFC in the same year.

QUESTIONS

1. Do you agree that if a copy (licence-to-use) is acquired via regular annual payments, the payments should be recorded as financial lease transactions if it can be established that the purchaser intends to use the copy repeatedly in production until the end of its economic life. Intent to renew the licence to use repeatedly can be determined by asking if significant associated costs are incurred on acquisition. For example, for software, the costs involved in training or developing new systems based on the software can be used to determine intent. For other copies, however, intent to renew the licence to use repeatedly is likely to be less common.

2. Do you agree that when the acquisition of a licence to use a copy is judged to be capital formation then the full value of the software reproduction should be recorded as fixed capital formation at the time of acquisition, with annual licence payments corresponding to interest payments thereafter, following the usual national accounts rules for financial leases? When this is not practical, it is acceptable to capitalise the annual licence payments as and when they occur and record as CFC in the same year.