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DRAFT ISSUES PAPER

ASSET BOUNDARY FOR INTANGIBLE NON-PRODUCED ASSETS – ISSUE 29

Other intangible fixed assets – Issue 13

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WORKING PARTY ON NATIONAL ACCOUNTS

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DRAFT ISSUES PAPER

ASSET BOUNDARY FOR INTANGIBLE NON-PRODUCED ASSETS – ISSUE 29

Other intangible fixed assets – Issue 13

Canberra II meeting, Geneva, September 2005

Charles Aspden, OECD

Executive summary

1. This paper deals with two issues *Asset boundary for intangible non-produced assets* and *Other intangible fixed assets*. The first issue concerns the question, "should instruments involving the securitisation of future receipts of government be recorded as intangible non-produced assets?" It is argued in the paper that they should not and the definitions given in the SNA should make that clear. Furthermore, it is proposed that the category "other intangible non-produced assets" should be eliminated. The second issue concerns what is meant to be included in the asset category "other intangible fixed assets". The description given in the 1993 SNA implies it is the output of R&D that has not been patented but to which access is restricted to the unit concerned. With the decision to record all expenditure on R&D that is protected as fixed capital formation, this category appears to be redundant. Accordingly, it is recommended that it be eliminated.

<u>*Recommendations*</u>

2. There are three recommendations:

i) The definition of an asset and the definition of an intangible non-produced asset given in the SNA should make clear that the securitisation of government revenue and expected future government revenue are not assets in the system.

ii) The category "other intangible non-produced assets" should be eliminated, and the category "leases and other transferable contracts" should be redefined to exclude the requirement of transferability.

iii) The category "Other intangible fixed assets" should be eliminated.

Introduction

3. *Asset boundary for intangible non-produced assets* (issue 29) concerns the question, "should instruments involving the securitisation of future receipts of government be regarded as intangible non-produced assets?", and *Other intangible fixed assets* (issue 13) concerns the question, "what is intended to be included in this category?" We begin by addressing issue 29.

Asset boundary for intangible non-produced assets

Background

4. This issue arose when some European governments raised money by securitising future income receipts. Eurostat's Manual on Deficit and Debt gives the following definition of securitisation (underlined by the author of the present paper): "*Securitisation is where a unit, named the originator, transfers the ownership rights over financial or non-financial assets, or the right to receive specific future flows, to another unit named the securitisation unit, that pays the originator from its own source of financing*." Typically, there is securitisation when the originator receives a payment today from the transfer of ownership rights to a securitisation unit (often a Special Purpose Vehicle) of an asset or of a series of future flows of receipts. The payment is financed by the securitisation unit by the issuance of securities (thus the name "securitisation") that are backed on the assets or on the specific future flows.

5. One example of securitisation was the transfer of ownership rights by a government of the future receipts of its public lottery. In this case, the securitisation unit issued securities backed on the future earnings of the lottery and paid the government with the proceeds of this issuance.

6. Should such transactions be recorded as the sale of an asset or as borrowing by government? Eurostat has developed a set of rules for deciding such matters, but it was not helped in doing so by the definitions given by the 1993 SNA regarding intangible non-produced assets: they are not clear cut and are open to different interpretations. Before proceeding further it is pertinent to review the current situation with intangible non-produced assets and the recent decisions concerning them made by the AEG.

7. The intangible non-produced asset category currently comprises the following:

- Patented entities
- Leases and other transferable contracts
- Purchased goodwill
- Other intangible non-produced assets

Patented entities

8. With the agreement of the AEG to record expenditures on R&D as GFCF, patented entities will no longer be recognised as non-produced assets in the system and they will be subsumed into R&D produced assets.

Leases and other transferable contracts

9. The SNA says that an asset in this category exists if the lessee has the right to convey the lease to a third party independently of the lessor. The Canberra II Group has agreed recently that if the free market price of an asset exceeds the payment due under a lease then an asset should be recorded when the sale of the lease is legally and practically realisable. In the case of payments to government to undertake an activity with no underlying asset, the Canberra II has agreed that they be treated as prepayments of a tax.

Purchased goodwill

10. This is a catchall of assets not recognised by the SNA elsewhere that account for the difference between the sale price of an enterprise as a going concern and the sum of its assets less liabilities. The

unrecognised assets are thought to include brand names, logos, domain names, franchise rights, etc. The AEG has agreed to all the Canberra II recommendations on this issue, which are reproduced below.

i) An asset class "Purchased goodwill and marketing assets" should replace the existing "Purchased goodwill". Marketing assets is the name given to brand names, logos, domain names, franchise rights and the like.

ii) The economic nature of purchased goodwill and marketing assets should be clarified along the lines presented in this paper.

iii) Valuation principles for purchased goodwill should be applied consistently, irrespective of whether the entity is a listed or unlisted corporation, a quasi corporation or unincorporated. They should be calculated as the excess of the purchase (or takeover) value of a business over the value of the other assets and liabilities otherwise identified in the SNA system for that business.

iv) Internally generated goodwill should continue to be excluded, except where its value is evidenced by a sale. In the case of internally generated goodwill, this occurs only with the sale of a business. In the case of marketing assets it can also occur with their independent sale.

v) The assets should continue to be classified as non-produced assets, even though their value is often driven by productive activity. However, further consideration will be given by the Canberra II Group to whether a term can be found that better reflects the nature of these assets. This will be addressed in the issues paper concerning Classification and terminology of assets (issue 27)[1].

vi) The assets should not be amortised at a predetermined rate but made subject to an impairment test consistent with the international accounting standards for these assets

Other intangible assets

11. This category is used for assets not elsewhere categorised. Several EU countries currently record mobile phone licences in it.

Securitisation and anticipated income

12. In most cases of securitisation of future income flows, it is not the rights to the income that are used as collateral, but the obligation of the government to use a sufficient amount of the future income to repay the borrowing in full. If more income is earned than is needed to repay the borrowing, the excess is retained by the government. Because receipts of future income are uncertain, usually "rights" to considerably more income than is necessary to repay the borrowing is used as collateral.

13. If the rights to future government revenue could be an asset, then all future government income—in other words, the power to tax—would be an asset. It is agreed that the power to tax is not an economic asset for the purpose of the SNA.

14. Recognising anticipated income as an asset would be similar to valuing a zero coupon bond at its maturity value rather than at its current market value or valuing a fixed asset with all expected benefits at their undiscounted values. We clearly do not do that in the SNA and should make it clear that using the likelihood of future income as collateral does not create an economic asset.

[1] One suggestion is that it be renamed "other non-financial assets" and be at the same classification level as "produced assets" and "natural assets".

15. Finally, it should be noted that observing that the government is likely to collect a certain type of income in the future has no effect on the country's productive capacity. As such, the anticipated income cannot be a non-financial asset.

16. Thus, there is clearly a need to make it clear in the SNA that anticipated future government revenue is not an asset, and certainly not a non-financial asset. What to do? First, it can be made clear in the definition of an asset that the securitisation of anticipated government revenue is excluded and this can be repeated in the definition of intangible non-produced assets. Second, the category "other intangible assets" can be eliminated. As long as this category exists, there is the potential for inventive accountants to attempt to use it to create phoney assets. Presumably, mobile phone licences have been put in this category because they were not transferable, and so could not be put in "leases and other transferable contracts". The solution is to either create a separate category for mobile phone licences or change the definition of "leases and other transferable contracts" to allow transferable contracts. It has been argued before that transferability is a weak condition because an enterprise owning a licence or a lease can always be taken over by another enterprise. Therefore the second option is preferred.

17. In page 310, intangible non-produced assets are defined as: "… constructs of society. They are evidenced by legal or accounting actions, such as the granting of a patent or the conveyance of some economic benefit to a third party. Some entitle their owners to engage in certain specific activities and to exclude other institutional units from doing so except with the permission of the owner. Intangible non produced assets consist of patented entities, leases and other transferable contracts, purchased goodwill and other intangible non-produced assets."

18. In page 295 (paragraph 13.62) the SNA explains: "Intangible non produced assets entitle their owners to engage in certain specific activities or to produce certain specific goods or service and to exclude other institutional units from doing so except with the permission of the owner. The owners of the assets may be able to earn monopoly profits by restricting the use of the assets to themselves. Included are patented entities, leases and other transferable contracts, and purchased goodwill."

19. The first definition (page 310) is quite general. First, the term "*construct of society*" is quite vague and leaves open a number of possibilities. Second, the existence of "an *accounting action, such as the conveyance of some economic benefit to a third party*" is also a quite general criterion. The following examples in the paragraph are not exhaustive and appear to leave the door open for such things as the securitisation of anticipated government revenue.

20. The second definition (page 295) is more specific and makes it clear that the ownership of the asset entitles the owner to engage in a productive activity from which it earns income. This clearly excludes the securitisation of government revenue, in which the purchaser of the asset does not engage in any productive activity at all.

<u>*Recommendations*</u>

21. The following changes should be made to the SNA

i) The definition of an asset and the definition of an intangible non-produced asset should make clear that the securitisation of government revenue and expected future government revenue are not assets in the system.

ii) The category "other intangible non-produced assets" should be eliminated, and the category "leases and other transferable contracts" should be redefined to exclude the requirement of transferability.

Other intangible fixed assets

22. Other intangible fixed assets are defined as (page 308) "New information, specialized knowledge, etc., not elsewhere classified, whose use in production is restricted to the units that have established ownership rights over them or to other units licensed by the latter. This would seem to comprise the outputs of research and development (R&D) not included in patented entities (and which are classified as intangible non-produced assets), but to which access is restricted to the unit concerned. With the decision by the AEG to record all expenditure on R&D that is protected as fixed capital formation, the other intangible fixed assets category appears to be redundant.

Recommendation

23. The category "Other intangible fixed assets" be eliminated.