

Amortisation of SAP License and Accounting for Annual Renewal Fee

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

1. A company incorporated as a wholly owned Government company under the Companies Act, 1956 during the year 1984-85 is engaged in construction and operation of thermal power plants in the State of Odisha. The company had set up two power plants of 2 x 210 MW (units I and II that is Stage-1) as its maiden venture in the district of Jharsuguda known as IB Thermal Power Station and the units were commercially operated during December 1994 and June 1996 respectively. Power generated from units I and II is sold to A Ltd, a Government of Odisha Undertaking at a tariff determined as per Bulk Power Purchase Agreement executed during 1996. During 1999, as a part of power sector reforms, the Government of Odisha disinvested 49% of the shares in favour of ABC Corporation, USA, the strategic investor. The company prepares its annual financial statements as per the provisions of the Companies Act, 1956 as amended from time to time.
2. During the year 2008-09, the company has issued Request for Proposal (RFP) for inviting offers from bidders for 'Implementation of SAP ERP, Non-SAP Applications and related IT Infrastructure along with Post-implementation support with Facility Management'. In the bidding process, SAP licenses with perpetual rights were procured from M/s SAP India at a cost of ₹69 lakh for implementation of SAP ERP. Besides above, annual licence fee of ₹16 lakh, revised from time to time, is payable every year. However, due to some internal issues, evaluation of bids for awarding of contract for appointment of agency, procurement of the non-SAP application and related IT infrastructure along with post-implementation support with facility management could not be completed and SAP licence could not be used in the absence of implementation of SAP.
3. Relevant conditions granted by the SAP India as per 'SAP Software End-User Value License Agreement' are given below. This agreement was signed between SAP India and the company on procurement of SAP licenses:
 - (a) SAP grants, a non-exclusive, perpetual (unless terminated in accordance with Section 5 herein) license to use the Software, Documentation, other SAP Proprietary Information, at specified site(s) within the Territory to run Licensee's internal business operations and to provide internal training and testing for such internal business operations and as further set forth in Appendices hereto. This license does not permit Licensee to (i) sub-license or rent the Software or Documentation or (ii) use the SAP Proprietary Information to provide services to third parties (e.g., business process outsourcing, service bureau applications or third party training). Business Partners may have screen access to the Software solely in conjunction with Licensee's Use and may not Use the Software to run any of their business operations.
 - (b) Licensee agrees to install the Software only on hardware identified by Licensee pursuant to this Agreement that has been previously approved by SAP in writing or otherwise officially made known to the public as appropriate for Use or inter-operation with the Software (the "Designated Unit"). Designated Units may not be shared for the purposes of Software Use with companies/entities that are not defined as Licensee or authorized Affiliates hereunder. Any individuals that use the Software including employees or agents of Affiliates and Business Partners, must each be licensed as a Named User. Use may occur by way of an interface delivered with or as a part of the Software, a Licensee or third-party interface, or another intermediary system."

The querist has separately clarified that perpetual rights of SAP licenses mean that the licence will continue unless terminated as per clause 5 of the 'SAP Software End-User Value License Agreement' (a copy of which has been supplied by the querist for the perusal of the

Committee). Further, annual renewal fee is payable as per the agreement for the enterprise support and applicable from the effective date of agreement. If annual fee is not paid for updating the license, there would be violation/breach of the 'SAP Software End-User Value License Agreement' and accordingly, it may result into the cancellation of SAP license as per the agreement. The fee is only paid as per the terms and conditions of contract. Practically, no service is received against such payment.

4. As per clause 5.1. of the agreement, "This Agreement and the license granted hereunder shall become effective as of the date first set forth above and shall continue in effect thereafter unless terminated upon the earliest to occur of the following: (i) thirty days after Licensee gives SAP written notice of Licensee's desire to terminate this Agreement, for any reason, but only after payment of all License and Maintenance Fees then due and owing; (ii) thirty days after SAP gives Licensee written notice of Licensee's material breach of any provision of the Agreement (other than Licensee's breach of its obligations under Sections 6 or 10, which breach shall result in immediate termination), including more than thirty days delinquency in Licensee's payment of any money due hereunder, unless Licensee has cured such breach during such thirty day period; (iii) immediately if Licensee files for bankruptcy, becomes insolvent, or makes an assignment for the benefit of creditors".
5. On procurement of SAP ERP license during the year 2008-09, an amount of ₹69 lakh was booked to 'Capital Work in Progress (CWIP)' account and kept for capitalisation along with SAP implementation.
6. Statutory auditors of the company during their audit for the year 2009-10 have given the

following observation on accounting of SAP ERP licenses under the head 'Capital Work in Progress':

"CWIP includes ₹68.79 lakh for the SAP license fees paid in December 2008 which is not capitalised and hence not amortised due to the absence of any accounting policy for such expenditure in view of annual maintenance charges being paid for the year 2009 and 2010. *Such license in the nature of intangible asset is available for use even though not implemented and as per Accounting Standard (AS) 26 'Intangible Assets,' intangible asset's amortization should commence from the time the asset is available for use.*" (Emphasis supplied by the querist.)

Based upon above observation of the statutory auditors, expenses incurred towards procurement of SAP licenses have been capitalised during the year 2010-11 and amortised from the year 2009-10 as per the following significant accounting policy of the company:

"Cost of computer software recognised as intangible asset is amortised on straight line method over a period of legal right to use subject to maximum ten year."

7. The querist has stated that the Comptroller and Auditor General (C&AG) of India, while conducting supplementary audit under section 619(3) of the Companies Act, 1956 for the financial years 2012-13, has raised observations on accounting treatment of SAP ERP licenses on the basis of observation of statutory auditors for the year 2009-10. The observations of C&AG of India and replies of management are given below:

Observations	Replies of Management
Intangible Assets (Note-11) Software and SAP license (Net) – ₹46.65 lakh	
The company paid ₹0.69 crore towards license fee in February 2009, and capitalised the amount during the year. Further, ₹0.68 crore was annually paid towards Annual Enterprise Support (AES) fee for software and SAP maintenance upto March 2013 and charged to profit & loss accounts in these years. As the required software was not procured and installed as on the date of the balance sheet entire expenditure on this account should have been booked to capital works in progress.	Observation of audit that the software not procured is not correct. The company procured the SAP ERP ECC 6.0 software licence from SAP India for implementation of the SAP project and the end user licence agreement (EULA) was signed between the company and SAP India on 27 th December, 2008 on payment of ₹68.79 lakhs.

Observations	Replies of Management
This has resulted in understatement of capital work-in-progress by ₹1.37 crore, profit for the period by ₹0.96 crore and overstatement of fixed assets by ₹0.41 crore (net of depreciation ₹0.28 lakh).	<i>The License is for unlimited period and updated only on payment of Annual Enterprise Support fee. On signing of agreement, the software covering modules such as FICO, MM, PM, PS, HR, Pay Roll, ESS etc. were received by the company.</i> As per paragraph 63 of AS 26, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. <i>Amortisation should commence when the asset is available for use.</i> Since the asset is available for use, the company accepted observations of statutory auditors (accounts for the year 2009-10) and based upon their advice amortised the same over ten years in compliance to AS 26. There is no understatement of Capital Work-in-Progress by ₹1.37 crore, profit for the period by ₹0.96 crore and overstatement of fixed assets by ₹0.41 crore (net of depreciation ₹0.28 lakh).

(Emphasis supplied by the querist.)

8. Similarly, C&AG of India, while conducting supplementary audit under section 619(3) of the Companies Act, 1956 for the financial year 2013-14, has raised draft observations which were also replied in line with the replies for the year 2012-13. C&AG of India instead of retaining the observation has informed the following vide its letter dated 28.08.2014:

“In course of supplementary audit of the above mentioned accounts, it is pointed out, (POM-3) that to obtain end user license for SAP ERP 6.0 software, the company signed end user licence agreement with M/s SAP India on 27.12.2008 and paid ₹68.79 lakh on 16.02.2009. In terms of the end user license agreement, the company was to pay annual enterprise support fee @ 22 percent of the license fee excluding taxes. The company capitalized the intangible asset at ₹68.79 lakh during the year 2008-09 on the ground that after payment of the license fee, the asset was available for use. In this context the observation of the statutory auditors on the annual accounts 2009-10 was accepted by the company and based on their advice the company amortised the same over a period of ten years from the year 2008-09 citing compliance to AS 26.

However, scrutiny of records revealed that till 31st March, 2014, the implementation

of SAP ERP could not be made for selection of partner. Thus, the asset was not ready to use even by the end of the financial year 2013-14. The payments made for acquisition of end user license as well as for the annual enterprise support fee should have been debited to CWIP instead of charging to statement of profit and loss. In the absence of implementing agency, the asset though available with the company but was not ready to use. Hence, the criteria for recognition of intangible assets as per AS 26 are not met. The amount incurred should have been booked under Capital Works in Progress till the asset is ready to use.

The above observation may be considered and necessary accounting effect may be given during finalisation of accounts for the F.Y. 2014-15.”

9. In this regard, the opinion on Query No. 2 of Volume XXVI of the Compendium of Opinions, issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) has been referred to by the querist. As per the opinion of the Expert Advisory Committee, the expenditure incurred on or after 1.04.2013 regarding SAP license fees and any further expenditure should be recognised as intangible assets as per paragraph 10 of AS 26 and amortised over the period of life.

10. The querist has further stated that subsequently, the company invited the bids during the year 2014-15 for “appointment of Agency for Implementation of SAP ERP, Non-SAP Applications and related IT Infrastructure along with Post-Implementation support with Facility Management at the company” and evaluation of technical offers is in progress.

B. Query

11. In view of above facts and accounting requirement, the company seeks the opinion of the Expert Advisory Committee as to whether capitalisation of expenses on SAP ERP licenses and amortisation of the same over a period of 10 years as per the accounting policy in this regard and charging of the annual renewal fee to the statement of profit and loss before implementation of the SAP on the basis of observations of the statutory auditors for the year 2009-10 is in consonance with the Generally Accepted Accounting Principles and provisions of Accounting Standard (AS) 26, ‘Intangible Assets’. If not, what would be the accounting treatment?

C. Points considered by the Committee

12. The Committee notes that the basic issues raised in the query relate to the timing of commencement of amortisation of expenditure incurred on acquisition of SAP ERP licenses as a part of intangible asset as per the principles of AS 26; and accounting for annual enterprise support or renewal fee (hereinafter referred to as the ‘renewal fee’) incurred by the company subsequent to the acquisition of such licenses. Accordingly, the Committee has considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, method of amortisation, determination of useful life for amortisation of SAP ERP licenses, legal interpretation of SAP Software End-User Value License Agreement, etc.
13. The Committee notes from the Facts of the Case that the company has acquired SAP ERP license from SAP India during the year 2008-09, which could not be implemented due to some internal issues related to non-completion of technical evaluation of bids for awarding of contract for appointment of agency, procurement of the non-SAP application and related IT infrastructure along with post-implementation support with

facility management (hereinafter referred to as ‘non-SAP applications and facilities’). The Committee further notes that the company capitalised the SAP ERP license as an intangible asset on the advice of the statutory auditors and is amortising the same even though, it could not be implemented. However, the C&AG is of the view that since the software has not been installed and since implementation of SAP ERP could not be made for selection of partner for non-SAP applications and facilities, the asset though available with the company but was not ready to use and, therefore, the expenditure incurred on acquisition should have been booked as ‘capital work in progress’ till the asset is ready to use. Accordingly, as per the views of the C&AG, the company should not also commence amortisation of such expenditure. In this regard, the Committee notes paragraph 63 of Accounting Standard (AS) 26, ‘Intangible Assets’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’):

“63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.”

The Committee notes from the above that amortisation should begin when the asset is ‘available for use’. The Committee is of the view that the term ‘available for use’ should be construed to mean when the asset is in the condition and location necessary for it to be capable of operating for its intended use. Therefore, in the extant case, the Committee is of the view that the company should determine when the license is in the condition necessary for it to be capable of operating for its intended use. In this regard, the Committee notes from the Facts of the Case that the license cannot be used till the non-SAP applications and facilities are also ready. Thus, SAP license cannot be used independently in the absence of Non-SAP applications and facilities and therefore, the implementation of SAP license is a composite arrangement requiring both SAP and Non-SAP applications and facilities. Accordingly, considering the above requirements of AS 26,

SAP license can be considered to be 'available for use' only when Non-SAP applications and facilities are also ready. Therefore, the Committee is of the view that till the SAP license is not 'available for use' as discussed above, the same should be classified as 'intangible asset under development' in the financial statements and thereafter it should be recognised as a part of the 'intangible asset'. Thus, the treatment made by the company in this regard is not appropriate. In this context, the Committee also wishes to point out that apart from the above-mentioned accounting treatment, the company should also assess at each balance sheet date whether there is any indication that the asset recognised as above may be impaired considering the requirements of Accounting Standard (AS) 28, 'Impairment of Assets', notified under the Rules. Moreover, it is imperative to note that as stated in paragraph I (14) of Illustration A of AS 26, "there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years." Accordingly, irrespective of the impairment assessment performed under AS 28, the company should assess the technological obsolescence of the SAP license and recognise an appropriate write down, as required.

14. With regard to accounting for annual renewal fee incurred by the company subsequent to the acquisition of such licenses, the Committee notes the following paragraphs of AS 26:

"59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

- (a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and***
- (b) the expenditure can be measured and attributed to the asset reliably.***

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense

if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset."

From the above, the Committee is of the view that subsequent expenditure on renewal of license should be expensed if it is required only to maintain the asset at its originally assessed standard of performance and only that expenditure can be capitalised which enables the asset to generate future economic benefits in excess of its originally assessed standard of performance. The Committee notes from the Facts of the Case that the querist has specifically stated that the fee is only paid as per the terms and conditions of contract and practically, no service is received against such payment. Further, if annual fee is not paid for updating the license, there would be violation/breach of the 'SAP Software End-User Value License Agreement' and accordingly, it may result into the cancellation of SAP license as per the agreement. Accordingly, the Committee is of the view that annual fee in the extant case is a period cost which is incurred to continue to retain the license and does not generate future economic benefits in excess of originally assessed standard of performance of the license. The Committee is also of the view that although the annual renewal fee may be incurred during the period when the license is in the process of being made 'available for use', i.e., being processed to be placed in the condition and location necessary for it to be capable of operating for its intended use, but it is not an expenditure to make the asset 'available for use'. Accordingly, the Committee is of the view that the expenditure on annual renewal fee cannot be capitalised and should be expensed in the statement of profit and loss. Thus, the

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accounting treatment made by the company in this regard is appropriate.

D. Opinion

15. On the basis of the above, the Committee is of the view that the SAP license can be considered to be 'available for use' only when Non-SAP applications and facilities are also ready. Therefore, till the SAP license is not 'available for use', as discussed in paragraph 13 above, the same should be classified as 'intangible asset under development' and thereafter it should be recognised as part of the 'intangible asset'. Further, as discussed in paragraph 13 above, such SAP license should be tested for impairment and write down for technological obsolescence. Thus, the treatment made by the company in this regard is not appropriate. The expenditure on annual renewal fee in the extant case is incurred to continue to retain the licence and does not generate future economic benefits in excess of originally assessed standard of performance of the license. Thus, it cannot be capitalised and should be expensed in the statement of profit and loss. Thus, the accounting treatment made by the company in this regard is appropriate, as discussed in paragraph 14 above.

- 1 The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
- 2 The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on April 23, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
- 3 The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty four volumes. A CD of Compendium of Opinions containing thirty four volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
- 4 Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
- 5 Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.

