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Issue 21

Contracts and leases of assets

**LEASES AND LICENCES
(part 1)**

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Executive summary:

The 1993 SNA introduced the asset category of "leases and other transferable contracts" but doubts have been expressed over what exactly the coverage of this item was meant to be. Further, some readers of the SNA interpret differently the guidance on when leases are to be treated as operating or financial. The Canberra II Group, as part of its mandate has reviewed all the circumstances in which leases, licences and contracts impact recording in the accounts. The recommendations presented in this paper are part clarification and part interpretation of the existing guidelines. They cover the use of fixed assets, the use of natural resources and other contracts, leases and licences which may have a value to the holder quite distinct from the subject of the agreement.

This paper is one of a number which bear on this subject. Others include issue number 21b on government permits as taxes, issue number 24 on PPP schemes, issue number 31 on the treatment of water, issue number 18 on the use of natural resources by non-residents, issue number 27 on the classification and terminology on non-financial assets and issue number 30 on the definition of an asset. All of these arise from discussion in the Canberra II Group and all represent a clear majority position of that group. However, there are some aspects of the items discussed in this paper which were not entirely resolved in the last meeting of the group in September. These are the subject of an e-consultation of the members of the Canberra II Group. The results of this consultation will be presented to the AEG. The questionnaire sent out is also available as part (2) of this issues paper.

Consequences of the recommendations

None of the proposals here represent changes which would have a major impact on GDP or other macro aggregates. The size of any change will depend on how far present country practice conforms to the clarifications put forward here. Nor are there any significant changes suggested to the means of recording transactions associated with the items discussed. For that reason no detailed examples are presented either.

As far as possible the suggestions are close to business accounting standards; no particular problems of implementation are seen as compared to the present situation.

The topics addressed here would have some consequences for GFSM, the OECD manual on capital stocks and, possibly, on the compilation of financial statistics in so far as extensions to the coverage of financial derivatives are proposed.

Background

The methods of treating leases and licences in the 1993 SNA has grown up rather in the manner of "case law" being established on a case by case basis. While some treatments have similarities with one another, until now there has been no comprehensive overview of how leases and licences are treated in the SNA. The Canberra II Group (CG) has been addressing this problem, bit by bit, over all its meetings. This paper summarises the overview now achieved and the recommendations made by the CG in Geneva in September.

There are three main areas which have been examined in detail,

Leases on fixed assets,

Leases and permissions to use natural resources,

Other leases, licences and contracts

Subsequent sections discuss the recommendations made by the CG and present them for consideration by the AEG. There was one major issue which was not resolved at the last CG meeting. This was the appropriate treatment when the permission to use an asset is for less than its full life and the legal owner resumes ownership as some point. A further section discusses the possibilities here. A questionnaire on this has been sent to members of the CG to seek their views on this and their views will provide input to the AEG as with an e-consultation among the AEG.

The paper also advocates establishing a set of basic guidelines for the treatment of leases and licences and contracts to be included in the SNA to provide guidance for special cases not considered or new types of contracts which may appear in future.

Leases on fixed assets

The distinction between operating and financial leases

Most contracts in relation to fixed assets are in the form of operational or financial leases. The CG has agreed that the present distinction between these leases is broadly satisfactory but that some extra clarification would be beneficial. Here is some suggested text by way of clarification.

All contracts concerning fixed assets whose inflation adjusted prices are expected to decline over their service lives represent the terms of either an operating lease or a financial lease. They are not assets in their own right.

*An **operating lease** is identified by the fact that the lessor undertakes an economic activity associated with the maintenance and repair of the asset being leased and is responsible for these; the asset appears in the balance sheet of the lessor. A **financial lease** is one where the asset plays no technical part in the production of the lessor and it is the lessee who is responsible for maintenance and repair of the asset; the asset should appear in the balance sheet of the lessee. It will tend to be the case that operational leases are shorter than financial leases and that financial leases tend to cover most or all of the economic life of the asset but this is indicative, not determining¹.*

The CG was asked whether they agreed with the suggestions here, in particular that the time of a lease is indicative and not determining and that a financial lease does not have to be for the whole life of the asset. They agreed that the distinction between operating and financial

¹ There is a difference of interpretation over what the SNA prescribes. In para 6.116 (b), it specifies that under an operating lease, "the user does not undertake to rent the equipment for the whole of the expected life of the equipment". The discussion on financial leases in 6.118 does not mention the life of the asset in connection with the period of the lease explicitly; it simply says "the lessee contracts to make payments which enable the lessor, over the period of the contract, to recover all, or virtually all, of his costs including interest". There are those who see this as specifying that any lease for less than the whole of the asset's life MUST be an operating lease. Others do not read the text this way. There is thus a question about whether what is suggested in italics is a change to the SNA or a clarification. This point is included in the e-consultation also.

leases was determined according to whether the lessee should be regarded as the economic owner of the asset or not using general and indicative criteria of risk and reward².

Q1: Does the AEG agree on this distinction between operating and financial leases?

Q2: Does the AEG agree that operating and financial leases are not assets in their own right?

Financial lease considerations

There are a number of questions about financial leases that need clarifying in the SNA. If the length of the lease and the payments each year due under the lease are known, then it is possible to calculate the net present value of the payments under the lease and designate this as the value of the asset subject to the lease. Every year, this value decreases because the length of the lease is one year shorter and increases in value because future payments are one year nearer. It would seem consistent with the treatment of the changes in the value of the asset to specify that the first of these represents repayment of principle and the second represents interest.

There is a further question associated with a financial lease. Should there be a financial service attributed to the lessor (usually but not always a financial institution)? If so, how should it be established and what does it do to the calculations suggested above? Is the service rendered throughout the period of the lease or only on inception? Or, which would be simpler but may not correspond to reality in all cases, do we suppose that any financial service would be represented by an explicit fee?

The CG recommended that a financial service may be provided by a lessor. If the lessor is a financial institution, this service is reflected in FISIM.

Q3: Does the AEG agree to clarify the separation of the payments under a financial lease as indicated above?

Q4: Does the AEG agree with the CG position of the provision of a financial service in connection with a financial lease?

There is another problem concerning financial leases and that is when the lease is for less than the whole life of the asset at the legal owner resumes ownership when the lease expires. This issue was unresolved by the CG in September and is discussed in the Canberra II Group e-discussion paper.

Operating lease considerations

One subject of discussion arising in the CG was how to deal with the case where payments due under a lease no longer represent the amounts that would be receivable if a new lease could be negotiated. The first recommendation by the CG was that the market price under a lease should be the amount payable under the lease. This is the price which prevails and no hypothetical price should be substituted for these payments.

Q5: Does the AEG agree that the payment due under a lease agreement represents the market price even if a newly leased identical asset would command a different price?

² This is elaborated further in issue paper 30, Definition of economic assets

The effect of different prices

The CG discussed the position arising when the payment due under an existing operational lease differs from the price which could be obtained under a new lease. The example used was of a building with a long term fixed rent operating lease but where the rent which could be obtained by re-letting at the present time was higher. The first case considered is where the lessee is legally and practically able to sub-let the building at a higher rental. Two other cases were discussed, one where the lease fixed by the lease is less than could be achieved if the building were re-let but the lessee had no right to sub-let. The other was when the rent fixed by the lease is higher than the rent available if the building were to be re-let.

The CG agreed that if a lessee could legally and practically sub-contract the lease at a higher rent, he had an asset which added to his net worth and the lessor suffered a compensating decrease in his net worth. In other words, the value of the building to the lessor is "encumbered", that is he receives less rent than he could if the building were available to re-let at the current, higher price. The value of the building in the balance sheet of the lessor should be at the unencumbered value but there should be an entry for the value of the encumbrance offsetting this. The unencumbered value represents what the building could be sold for with vacant possession; the value of the encumbrance is the payment the lessor would have to give the lessee to forgo the lease.

If the lessee could not sub-let, then he has no asset representing the difference in rent applying to the building. Because there is no matching asset to the value of the encumbrance to the lessor, it was agreed that in this case the value of the building in the lessor's balance sheet should be the encumbered value. This is the amount he could sell the building for with a sitting tenant. This would still be equal to the value of the building with vacant possession less the payment the lessor would demand to forgo the lease but in this case the value to the lessor is contingent on the lessee offering a payment to leave and not an unconditional benefit.

If the price at which the building could be sub-let was lower than the fixed rent in the lease, and the lessee has a binding contract to continue the lease, then it is the lessor who has an asset and the encumbered value of the asset is higher than the unencumbered value. The balance sheet should still show the unencumbered value as the value of the building with the encumbrance representing an additional asset for the lessor and a reduction in net worth to the lessee. This is the amount the lessee would have to pay to another tenant to take over the lease or the amount he would have to pay the lessor to be released from the contract.

Q6: Does the AEG agree that if a lessee is able legally and practically to sub-contract a lease at a higher rental, this represents an asset for the lessee and a reduction in the net worth of the lessor? In this case the value of the object of the lease appears in the lessor's balance sheet at the unencumbered value with the reduction shown separately? Conversely, if the lessee is contractually obliged to pay a rent higher than the prevailing price, this represents an additional asset for the lessor and a reduction in the net worth of the lessee?

Q7: Does the AEG agree that if the lessee is not able either legally or practically to sub-contract a lease, the value of the object of the lease appears in the lessor's balance sheet at the encumbered value? In this case there is no separately identified asset belonging to the lessee.

A further important point established by the CG is that this case applies only to operating leases. There is no parallel in the case of an appreciating asset under a financial lease since the lessor has no asset separate from the agreed financial claim on the lessee. If the market price of an asset under a financial lease declines, then the value of the asset to the lessee

declines but he still has a financial liability towards the lessor determined by the original terms of the lease.

Q8: Does the AEG agree that these assets (or reductions in net worth) are only relevant in the case of operating leases?

Assuming there is an asset identifiable for either the lessee or the lessor, the question is what sort of asset. One suggestion is that it could be part of the class of "contracts, leases and licences.". Then the question arises of how the negative value to the lessor or lessee should be recorded. The CG was loathe to introduce non-financial liabilities and so one possibility would be to show a (non-financial) impairment of or enhancement of the asset. This option would ensure that the impairment (or enhancement), if recorded, could be shown in the non-financial part of the balance sheet close to the value of the object leased.

Another possibility discussed was to treat the asset as a sort of financial derivative. At first sight this seems a way to allow for the counterpart liability to be shown easily. However, further investigation suggests the analogy is very approximate. There is no risk being traded and any realisation of the potential asset by the lessee (say) involves a third party whereas financial derivatives are strictly two party contracts. Since it would not be practical for financial statisticians to collect information on these assets, it would in any case be inappropriate to designate them as financial assets. The question therefore is back to how to show the negative counterpart to the asset.

Q9: If the benefit which comes from a transferable/enforceable lease is regarded as a non-financial asset (under contracts, leases and licences), how should the negative counterpart be shown?

Prepayments of leases

The CG discussed whether prepayments made in relation to leases on assets represented separate types of assets. The conclusion was not and the way in which a prepayment is to be recorded depends on the exact terms of the lease contract.

A single up front payment authorising the use of the asset for more than a year under terms where the user acquires the risks and rewards associated with economic ownership of the asset (similar to the circumstances of a financial lease) is to be regarded as the acquisition of the asset. This may happen in the context of originals and copies.

A single up front payment covering multi-year payments under an operating lease, where the lessor retains economic ownership of the asset and provides services to the lessee over the life of the lease is to be regarded as a trade credit. Payments for services are recorded on an accrual basis over the term of the lease.

In some case, the lessee may make a large initial payment followed by smaller payments in succeeding years. The exact nature of these payments depends on the terms of the lease. One possibility is that the initial payment consist of the acquisition of an asset (whether a copy or piece of equipment) and the following instalments represent payments for services. Alternatively, the initial payment may contain an element of trade credit (deposit) if the contract is clearly an operating lease.

Q10: Does the AEG agree with this means of determining how pre payments for the use of assets are to be treated?

The CG noted that in some cases, one party to a collective project may contribute an asset in lieu of a financial payment. This could also be regarded as a form of "pre-payment".

Treatment of transactions in kind in the SNA would suggest that this should be recorded as a financial contribution followed by acquisition of the asset in question by the collective project.

Q11: Does the AEG agree with this position?

Permissions to use natural resources

There are basically three cases to consider.

Natural resources that have infinite lives and where use in production does not affect the nature or value of the asset. At the end of the lease, the legal owner resumes ownership.

Natural resources where demand exceeds the sustainable supply and permits are introduced to restrict demand.

Natural resources whose use in production eventually exhausts them.

Land

With the decision to maintain land improvements as fixed assets, this becomes something of a hybrid between the first of these cases and the treatment of fixed assets more generally, discussed in the previous section.

The SNA makes a distinction between produced and non-produced assets which is crucial to the portrayal of the asset in the production account. Produced assets form part of production supply and so must also form part of use, even if not in the same time period. Thus the use of a produced asset by a unit not the economic owner is shown as the provision of services and the corresponding payment is referred to as a rental. The use of a produced asset by the economic owner gives rise to operating surplus with no explicit recording of the service rendered (this is the whole debate about showing capital services) but only the decline in value shown as consumption of fixed capital.

Non-produced assets also contribute to the operating surplus of the user of the asset, whether the user is the economic owner or not. When the user is not the owner, payments to the owner are shown not in the production account (because there is no supply to match this use) but in the allocation of primary income account as property income. For land, this item has always been separately denominated as rent.

The decision to split land improvements from natural land will mean part of what was previously should have been shown as rent will now appear as rentals.

No depreciation of non-produced assets is shown in the SNA. This is at the heart of environmental accounting where it is argued such depreciation should be shown. There is no suggestion to bring this into the update of the SNA; it will continue to be shown, if at all, in a satellite account such as the SEEA. However, consumption of fixed capital of land improvements will continue to appear in the SNA, though the articulation of the change in opening to closing balance sheets will be clearer. Because land improvements are separated from natural land, no degradation of natural land will appear in the SNA, also as before.

Natural resources having infinite lives

Natural land is still the most universal natural resource which has an infinite life (ignoring degradation which does not enter the SNA) but there are others such as some water supplies and the radio spectrum.

A lease on land does not fit exactly into the operating or financial lease categories for leases on fixed assets. Land where an annual rent is payable is like an operational lease in that the owner retains title to the land and retains it on his balance sheet. However, unlike an operating lease, the owner has no production activity associated with the land since he is not involved in maintenance of it. There is no consumption of fixed capital chargeable to either the owner or the user. Further, payments to the owner are deemed to be property income, as just explained, and not provision of a service as is the case with an operating lease.

Nor does the financial lease model fit land very well. Because the value of the land does not decline over time, the payments made by the tenant to the landlord cannot be split into an element of property income and one of principal repayment; since the value of the land does not change with the passage of time, the payment is always entirely property income (rent). Further the practice of leasehold land is such that in some circumstances a single up front payment is made to cover rent for the entire period of the lease which may often cover 99 years. The lessee takes over effective economic ownership as in a financial lease but there is no continuing series of financial transactions with the lessor during the lease. Further, the initial tenant typically has the right to on-sell the remainder of the lease together with any buildings on it. At the end of the lease a new agreement between the tenant and landlord may be negotiated or the landlord may reclaim the land.

In these circumstances, and to avoid confusion over the treatment of leases, it may be desirable to introduce different treatments for natural resources³. For example, a resource lease could be introduced into the SNA with the following explanation to cover the case of regular payments.

*A **resource** lease is an agreement whereby the legal owner of a natural resource which has an infinite life makes it available to a lessee in return for a regular payment, recorded as property income and described as rent. The resource is recorded on the balance sheet of the lessor. No consumption of fixed capital is recorded in respect of the resource in the SNA in the accounts of either the lessor or lessee.*

The case where an up-front payment only is made for access to the resource is included in the discussion on shared assets in the Canberra II Group e-discussion paper.

Q12: Does the AEG agree to introduce the concept of a resource lease into the SNA along the lines proposed?

Natural resources subject to sustainability concerns

It is increasingly common for permits to be issued to allow the off-take of certain natural resources, such as fish or trees, or to allow discharge of waste materials into air or water bodies. In many cases, these are issued by government but there may be cases where an international agency allocates permits (as in the case of fishing for certain species for example). In accordance with the CG decision on permits (see issues paper 21b) permits

³ This proposition has emerged since the last CG meeting and is included in the e-consultation of the members.

issued by government which relate to a recognised asset represent an asset in themselves. Permits which do not relate to a recognised permit are treated differently. The case of water is described in a separate issues paper.

The CG recommends that when a fishing quota is allocated by international convention to a country, the value of the fish covered should, in principle be treated as an asset held by government on behalf of the nation. This would mean that fishing permits or quotas should be treated as assets. In the present classification they would fall under non-produced, intangible assets. In the proposed classification (see issues paper 27) this heading would be renamed "contracts, leases and licences". Even though issued by government, sometimes without cost, there are well-established secondary markets in them.

Q13: Does the AEG agree that fishing quotas represent assets to the holders? Can this be generalised to quotas or similar licences relating to all protected plant and animal species?

There is a question about how emissions permits allowing discharge of noxious substances into the atmosphere should be recorded. The SNA does not record the atmosphere as an asset which suggests treating these permits as taxes. Again, though, there is a market in these permits which is expected to develop and become important internationally. By convention, therefore, these permits could be treated in the same way as fishing permits.

Q14: Does the AEG think emissions permits should be recorded as taxes in the first instance and assets when they are traded in secondary markets or as assets from inception? Does this generalise to all environmental media used as "sinks"?

Exhaustible natural resources

For the most part, inanimate natural resources other than land are mainly used for extractive purposes. The licensor retains ownership of the resource, though this diminishes as extraction takes place. The licensee takes control of the resource, in the sense of having power to make decisions on the rate of extraction (possibly within some limits laid down by the licensor), but does not acquire ownership of the whole resource. In the case of profit sharing between the licensor and licensee, it is not just the case that the effective ownership is different in different time periods but that the returns from the asset are divided throughout the period of extraction again suggesting the possibility of divided ownership.

Attributing the whole of the deposit to the legal owner means that it is difficult to identify part of the operating surplus of the extractor with the resource being extracted. Attributing the whole of the deposit to the extractor reduces the apparent wealth of the legal owner and does not show the link between income (as royalty or share of profits) and the declining value of an asset.

The CG has found the question of attribution of the asset between the owner and extractor to be difficult and this is another of the issues subject to the e-consultation among members of the CG.

Other contracts, leases, licences

Permits

In Canberra, the CG decided that certain permits issued by government even if they were limited in number and bid for freely in an auction, were to be treated as taxes. The permits in question do not include the use of a specified asset but typically allow the permit holder to undertake designated activities for which a permit is necessary. Taxi medallions are an obvious example. There is a separate issues paper discussing this proposition.

However, the question arises of how such permits would be treated if they were issued by a unit other than government. The CG recommended that when there is an underlying asset, payments should be property income and when there is no underlying asset, payments should be recorded as a payment for a service.

Q15: Does the AEG agree with this recommendation?

Provision of goods in future

Contracts may be written or verbal agreements; they may or may not be couched in terms of a legal agreement. Most contracts are neither legal agreements nor even written. Nor are they potential assets. They are simply an agreement that A will provide B with a particular good at a given price. For most goods, the sale is imminent and there is thus no question of such a contract being considered an asset. For example, if I order something over the internet there is an implicit contract between myself and the vendor which is exhausted immediately the product is delivered. Similarly if I order an out of stock product from a shop. Such contracts are simply advance agreements about the terms of a transaction and we only record the transaction when it takes place, if necessary with an adjustment between the cash and accrual basis.

There are two cases when a contract to provide goods might be considered an asset. The first is when delivery of the good is to be in the distant future. An example is an order to purchase a new aircraft in some years' time at a price pre-specified in the contract. If the final price is higher than the contract price, the purchaser has a potential asset. If the contract is binding on the potential buyer, then it is an asset for the manufacturer.

This leads to the second case when agreements to provide goods in future may be considered as asset. This time the perspective is that of the producer, not the purchaser. A shipyard with a full order book is obviously more viable than a similar yard with an empty order book, in other words we would expect the former to have a higher net worth than the latter. A shop without formal orders but with a proven track record of the level of its sales probably has a higher net worth than one with a much worse record for sales or one which is completely new and thus untested.

The conclusion of the CG was that an option to buy goods in future should be treated as a (distinguishable) type of financial derivative. Other contracts to purchase goods are not assets. Even if a producer can claim with an acceptable level of probability that a given level of sales in the future is assured, this will represent an asset only to the extent that if the unit were sold, the level of the order book, and more particularly the profitability of it, would represent an element of goodwill. Equally if the order book were empty or included a loss making contract, this would lead to negative goodwill.

Q16: Does the AEG agree with these recommendations?

Provision of services in future

The arguments here are very similar to those for the provision of goods. One difference is that contracts for services often refer to the repeated provision of services over a period of time. One example is the provision of electricity. Here, however, it is still usually the case that though the price may change over time, the price paid by the purchaser will continue to be equal to the market price.

The interesting exception is when a stream of services is to be provided into the future at a price fixed at the outset (possibly subject to some form of indexation). The classic example is the fee payable by a named football club to a named player. As with goods, the fact that

makes the footballer's contract a potential asset is that a gap opens between the contract price and an unconstrained price.

The CG concluded that most contracts to provide services are not assets but some contracts to provide services in future such as footballers' contracts, lead to assets currently described as non-produced intangible assets. (In this case, no party suffers a reduction in net worth so they are not similar to financial derivatives as in the case of goods.)

Q17: Does the AEG agree with these recommendations?

Basic principles concerning leases, licences and contracts

One reason why the CG spent so much time discussing this topic is that there is no generic guidance in the SNA on how contracts, leases and licences should be treated. Within the life of the update, it is quite possible new forms of contracts will emerge and need classifying within the System. For that reason, it seems useful to produce some broad guidelines which could be incorporated in the SNA for use in future.

Q18: Does the AEG agree that the SNA should contain some generic advice about the treatment of contracts, leases and licences?