



**STATISTICS DIRECTORATE**

**STD/NAES(2005)10**  
**For Official Use**

**National Accounts and Economic Statistics**

**LEASES AND LICENSES**

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*WORKING PARTY ON NATIONAL ACCOUNTS*

*To be held on 11 - 14 October 2005*

*Tour Europe - Paris la Défense  
Beginning at 9:30 a.m. on the first day*

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**JT00190470**

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# Leases and Licences

Anne Harrison

This note tries to summarise where we have reached on the question of leases and licences and focuses on questions which still remain to be resolved. It looks at (i) fixed assets, (ii) prepayments, (iii) land, (iv) other natural resources and (v) other contracts. It also tries to establish a set of basic guidelines for the treatment of leases and licences and contracts to provide guidance for special cases not considered or new types of contracts which may appear in future.

## **Fixed assets**

### Operating and financial leases

Most contracts in relation to fixed assets are in the form of operational or financial leases. The Group 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 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 determining.*

***Q1: Does the group agree 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?***

There are a number of questions about financial leases that need clarifying. 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?

***Q2: How does the AEG think the SNA should describe the allocation of payments under a financial lease into the elements of principle repayment and interest? Should a financial service be associated with a financial lease and if so how should it be identified?***

### Partitioning the ownership of assets

The Group has agreed that partitioning of an asset between two or more owners is acceptable but that it should be allowed only in exceptional cases. The SNA currently allow this in the case of assets held by corporations operating in more than one territory (see paras 14.27 and 14.34). One of these cases is that of a regional central bank. It is now proposed by BOPCOM that these institutions should be regarded as international institutions which would remove this exception.

It was noted that the IASB is considering the question and revised standards may recommend partitioning in certain circumstances at some future date. This possibility should be monitored.

One particular problem instance is that of PPP schemes. This is due for discussion under another agenda item.

A further instance considered was that of software licences and R&D where the developer retains an asset and the permission to use the software of R&D may represent an asset for the user. This problem has been resolved in the context of the treatment of originals and copies by establishing two sorts of assets each completely owned by a single unit.

Besides the PPP case, the case of natural resources owned by one unit and exploited by another needs to be considered. This is taken up below.

A question remains if an asset is leased on financial terms for less than the whole of its expected life. This is referred to again below.

### Market price exceeds lease payment

The Group agreed that the value of the asset was the price agreed in the contract between the lessor and lessee. The Group further agreed that when the market price for the use of an asset exceeds the payment due under an operational lease, the lessee has an asset if it is both legal and practical to sell the lease. This asset adds to the wealth of the lessee and detracts from the wealth of the lessor. The nature of the asset held by the lessee and the nature of the deduction of wealth of the lessee has still to be determined.

A suggestion is that the asset involved could be described as a “contract premium” or “premium on leased assets”. It would represent a non-produced asset and would appear in the accounts via the other changes in assets account. It is further proposed that non-financial liabilities should not be introduced into the System and thus the “contract premium” would appear as an asset with positive value for the lessee and appear as a negative element of wealth, an impairment of the asset’s value, for the lessor.

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.

***Q3: Does the Group agree (i) with the treatment of the premium for the lessee? (ii) with the terminology proposed? (iii) that the same entry should appear with a negative sign as an impairment of the lessor? (iv) this is only relevant in the case of operating leases?***

### **Prepayments**

The Group 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 authoring the use of the asset for more than a year is to be regarded as the acquisition of the asset. This may happen in the context of originals and copies. In other cases it may be treated as the acquisition of an asset under a financial lease but where the legal owner retains some residual value of the asset at the end of the period covered by the up front payment. This raises again the question of partitioning the ownership of the asset.

A single up front payment covering multi-year payments under an operating lease is to be regarded as a trade credit.

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.

The Group noted that in some cases, one party to a collective project may contribute an asset in lieu of a financial 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.

***Q4: Does the Group agree with this summary and extension of earlier discussions?***

### **Land**

The Group has decided to divide land into a part where activities such as land clearance add more to the value of the land than its original value and to treat this land as “produced”. Land in its original or natural state would continue to be treated as “non-produced”. When land has some “produced” element, it will be apportioned between “produced” and “non-produced” according to which part represents the greater value. Here the terms “natural” and “converted” are used in place of “produced” and “non-produced”.

There seem to be different views about whether most land would be natural or converted. One argument is that activities such as land clearance which took place a very long time ago, possibly centuries, will have been fully depreciated since then and so the that land will have reverted to being natural. The other view is that the depreciation is so very slow as to be negligible and so the land will still be converted. This matters in the present context to know which of the following circumstances would be the predominant one.

#### **Converted land**

As a fixed asset, converted land should be treated exactly as any other fixed asset. It can be subject to an operational lease, for example as in a caravan park, though this may not be very common.

Converted land can also be the subject of a long term lease where the lessee takes on all activities connected with the land and the lessor has no land-related activity. This sounds like a financial lease but since the land is not leased in perpetuity, there will be a residual value of the land for the lessor (landlord) and this value will increase as the lease shortens through the passage of time. The two obvious alternatives to permit this are the same two alternatives available for the treatment of the similar phenomenon under a PPP. Either there could be a capital transfer from the lessee to the lessor or a mechanism needs to be found whereby a financial claim by the lessor on the lessee is established and exchanged for the land at the end of the lease.

In addition, there is a need to clarify the nature of the property income payments made each year by the lessee to the lessor. Should this be treated as interest, as with any other financial lease, or, because the asset involved in land, albeit converted land, should this payment be shown as rent? If appropriate, rent (which might more adequately be described as rent on land) could be divided into rent on natural land and rent on converted land.

***Q5: How should a long term lease of converted land be shown in the accounts? If it is a financial lease how does the value of the land at the end of the lease convert back to the balance sheet of the landlord? Should the property income due under the lease be shown as interest or rent?***

***Q6: Does the solution for converted land concerning the transfer of ownership back from the lessee to the lessor apply to other financial leases where the lease is for less than the whole life of the asset?***

#### Natural land

The same questions apply to natural land as apply to converted land. There is an additional question to address. The lessor (tenant) of natural land might improve it to the status of converted land. This may happen when a farmer takes over land and clears it for farming or when a builder clears land for a building site. The capital services rendered by the land will increase as a result of this activity and depreciation will have to be recorded for this activity. Assuming the payments due each year under the lease were agreed on the basis of the land in its natural state, the value of the converted land will be higher as a result of the activity of the lessee. Is this a case where the value of the land should be apportioned with the lessor owning only the natural part and the increase in value attributed to the lessee? Even in such a case, it must be presumed that the land will eventually revert to the lessor and he will thereby acquire an asset of greater value than the one he originally leased.

***Q7: Is there a problem with a lessee changing the nature of an asset under a lease? When does this change affect the recording of the asset in the lessor's balance sheet? Can the mechanism of transferring an asset from the lessee to the lessor at the end of a lease accommodate an increase in value of the asset brought about by the lessee?***

#### **Other natural resources**

It is possible to think of a lease to use other natural resources, for example to use waterways for fish farming or radio spectra for communications, in such a way that the resource is eventually returned to the owner in the same state. However, for the most part 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.

Trying to set up a financial lease is fraught. It is most unlikely that at the initiation of the lease it is possible to determine the length of time over which extraction will occur, and the revenue from the extraction is uncertain since this will be determined by movements in prices and the impact of new discoveries and new extraction techniques. Any estimate of the value of a “loan” would be subject to major revisions year by year and the separation of the payments to the legal owner into a repayment of principle and interest would be contestable.

Though there are misgivings about separating the value of the deposit between two owners, the question to be address is not which is the correct treatment but which is the least bad.

***Q8: How does the Group think the ownership of a natural resource which is being run down should be shown, entirely in the balance sheet of the legal owner/licensor? Entirely in the balance sheet of the extractor/licensee? Split between the two? If so on which basis?***

### **Other contracts, leases, licences**

#### Permits

In Canberra, the Group decided that 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 question arises of how such permits would be treated if they were issued by a unit other than government. It is not easy to think of a convincing example, but this does not necessarily mean that such examples do not exist. One example I suggest is if a hotel “licences” taxis to queue on its ground to pick up customers from the hotel. It is possible to imagine that only a limited number of such permits were available and that there could be a market in them. This is not wholly different from a city licensing taxis to operate on its streets but clearly could not be termed a tax. In countries where not all natural resources are owned by government one could imagine the owner having an auction to decide who would be given extraction rights. Fishing quota are allocated according to international agreement. Governments are the parties to the allocation but can taxes be paid to a group of countries?

***Q9: If permits are issued other than by government, how should they be classified?***

There is a follow up question for the group to answer. The decision that permits issued by government are taxes changes the previous decision on mobile phone licences since these too will now be classed as taxes. The Group also agreed that when the permission extends for several years, the tax should be shown on an accrual basis with prepayments being recorded on an accrual basis over the period for which the licence is in force. However, for the taxi medallions, emissions rights and fishing quota, there can be a lively market in the licences since these meet the criteria of assets in that they convey future benefits to the holder. If a taxi driver sells his medallion to a colleague, how do we record it in the accounts?

***Q10: Does the Group confirm that licences issued by government should be recorded on an accrual basis covering the period of the licence? How should a sale of a licence be recorded in the accounts?***

## 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 where 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. There are two possible criteria to be considered here. The first is that the ultimate market price for the aircraft may differ from the price pre-specified in the contract. If the final price is higher than the contract price, the purchaser has a potential asset. If the final price is lower, the purchaser is likely to cancel the contract and buy on the same terms as everyone else unless special conditions prevail. If he has made an advance deposit which is non-returnable, he will buy the aircraft as long as the difference between the market and contract price is less than this deposit. Another possibility is that the nominal market price is lower than the contract price but lack of availability temporarily raises the price up to the contract price.

The second criterion in this case is the existence of a deposit for the future product. Clearly this is some sort of asset, if only a trade credit in favour of the future purchaser but it may be for consideration whether some other designation is appropriate in this case. If the deposit confirms the maximum price to be paid, this condition may not be significantly different from the preceding one.

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.

***Q11: Does the Group agree that most contracts to purchase goods are not assets. The potential exceptions are***

***when the market price of the good at the promised time of delivery differs from the contract price,***

***when a deposit is made by the purchaser against future delivery,***

***when a producer can claim with an acceptable level of probability that a given level of sales in the future is assured.***

## *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 the market price.

A contract for a one-off provision of services may also be a potential asset, for example the advance paid to a well-known author for his next book, even though it has not yet been written.

***Q12: Does the group agree that most contracts to purchase services are not assets, even when the contract specifies repeated or continuous provision over a period of time. The potential exceptions are***

*when the market price of the service at the promised time of delivery differs from the contract price,*

*when a deposit is made by the purchaser against future delivery,*

*when a producer can claim with an acceptable level of probability that the potential future earnings of an employee under contract is in excess of the contract payments.*

### **Basic principles concerning leases, licences and contracts**

Leases licences and contracts may relate to

The use of fixed assets

The use of natural assets

Permissions to engage in specified actions or activities

The provision of goods and services in future under agreed conditions

Leases licences and contracts between the owner of a fixed or natural asset (licensor or lessor) and a potential user (licensee or lessee) may be in the form of an operational lease or a financial lease.

The interpretation of the nature of the lease may be affected by timing questions (prepayments).

The recording of ownership of assets under financial leases and possibly other contract conditions (PPPs and extraction of natural resources) must allow for the eventual resumption of the residual value of the asset by the legal owner.

Financial leases and contracts for the future provision of goods and services may be subject to a further contract between the lessee and a third party. These contracts may have a market value when they are legally and practically tradeable and represent assets distinct from the subject of the primary contract.

When issued by government, permissions to use specified environmental resources or to engage in specific activities are to be recorded as a tax. The Group has yet to decide how any similar permits issued other than by government are to be recorded and how sales of permits issued by government are to be recorded.

***Q12: Does the Group agree with these general principles concerning the treatment of contracts, leases and licences?***