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# CHAPTER 15

## CONTRACTS, LEASES AND LICENCES

### INTRODUCTION

- 15.01 Contracts are agreements on the terms under which goods, services and assets are provided to the customer. Contracts representing straightforward sales of goods, services or assets determine the value, and time of recording, of the transaction, which in the case of goods is the change of ownership. The difference between the time of payment and time of recording is reflected in entries recorded as other accounts receivable or payable in the financial account.
- 15.02 Leases, licences and permits are contracts which determine the classification of payments and the economic ownership of assets; some of the contracts are a separate type of non-financial asset.

15.03 In this Chapter, the recording of various groups of complex contracts and their underlying flows and stocks are discussed in seven sections:

- (a) the distinction between operating leases, resource leases and financial leases;
- (b) permits to use a natural resource;
- (c) permits to undertake specific activities;
- (d) public-private partnerships;
- (e) service concession contracts;
- (f) marketable operating leases;
- (g) entitlements to future goods and services on an exclusive basis.

#### **THE DISTINCTION BETWEEN OPERATING LEASES, RESOURCE LEASES AND FINANCIAL LEASES**

15.04 Three types of leases of non-financial assets are distinguished (see Table 15.1):

- (a) operating lease;

- (b) resource lease;
- (c) financial lease.

Each of these leases relates to the use of a non-financial asset:

- in the case of operating leases and resource leases, there is no change of economic ownership and the legal owner continues to be the economic owner. Resource leases are used for natural resources, such as land and radio spectra. Operating leases are used for all other non-financial assets,
- in the case of financial leases, there is a change of economic ownership of the asset, and the legal owner of the asset is not considered to be the economic owner.  
Financial leases can apply to all non-financial assets, including in some situations natural resources.

15.05 Every entity such as a good and service, a natural resource, a financial asset or liability has both a legal owner and an economic owner. In many cases the economic and legal owners are the same. Where they are not, the legal owner has handed responsibility for the risk involved in using the entity in an economic activity to the economic owner along with the associated benefits. In return the legal owner accepts from the economic owner payments for another package of risks and benefits.

**Table 15.1 — The recording of three different types of lease**

Type of lease	Method of recording for the user
Operating lease (not for natural resources)	<p>The user is not the economic owner of the non-financial asset</p> <p>The rentals are recorded as payments for a service, intermediate consumption or final consumption expenditure by general government, households and NPISHs</p>
Resource lease (only for natural resources)	<p>The user is not the economic owner of the natural resource. Payments are rents (property income)</p>
Financial lease	<p>The user is the economic owner of a non-financial asset, financed by a loan from the lessor. The payments are for the most part re-payment of principal and payments of interest on the loan.</p> <p>Part of the interest payments may be recorded as FISIM when the lender is a financial intermediary. This payment is classified as intermediate consumption or final consumption expenditure by general government, households and NPISHs</p>

**Table 15.2 — The recording of three different types of lease, by type of transaction**

Type of transaction	Type of use, and asset involved
Intermediate consumption	Operating lease of produced assets, for example machines and intellectual property rights  FISIM services on a financial lease
Consumption of fixed capital	Only for produced assets, and only for the economic owner
Final consumption expenditure	Operating lease of consumer durables  Purchase of consumer durables (including when financed by a financial lease or hire purchase)  FISIM services on a financial lease to final consumers
Purchase of non-financial assets  Fixed capital formation  Acquisition of natural resources  Acquisition of other non-produced assets	  Purchase of produced assets (including when financed by a financial lease)  Purchase of natural resources, including the right to use to extinction  Purchase of the right to use a natural resource for an extended period, for example a fishing quota

Type of transaction	Type of use, and asset involved
Property income payments	
Rent	Resource lease, i.e. payment for the use of a natural resource
Interest	Financial lease, i.e. purchase of a non-financial asset financed simultaneously by a loan
Financial transaction: loan	Financial lease, i.e. purchase of a non-financial asset financed simultaneously by a loan

- 15.06 *Definition:* the economic owner of entities such as a good and service, a natural resource, a financial asset or liability is the institutional unit entitled to claim the benefits associated with the use of the entity in the course of an economic activity by virtue of accepting the associated risks.
- 15.07 *Definition:* the legal owner of entities such as a good and service, a natural resource, a financial asset or liability is the institutional unit entitled in law and sustainable under the law to claim the benefits associated with the entities.

## **Operating leases**

- 15.08 *Definition:* an operating lease is a lease whereby the legal owner is also the economic owner and accepts the operating risks and receives the economic benefits from the asset by charging for the use of it, in a productive activity.
- 15.09 One indicator of an operating lease is that it is the responsibility of the legal owner to provide for repair and maintenance of the asset.
- 15.10 Under an operating lease the asset remains on the balance sheet of the lessor.



15.11 The payments made for produced assets under an operating lease are referred to as rentals and are recorded as payments for a service (see Table 15.2). The character of an operating lease is best described in relation to equipment since operating leases are often for vehicles, cranes, drills, etc. However, any sort of non-financial asset may be subject to an operating lease. The service provided by the lessor goes beyond the mere provision of the asset. It includes other elements such as convenience and security. In the case of equipment, the lessor, or owner of the equipment, normally maintains a stock of equipment in good working order that can be hired on demand or at short notice. The lessor must normally be a specialist in the operation of the equipment. This is important in the case of highly complicated equipment, such as computers, where the lessee may not have the necessary expertise or facilities to service the equipment properly. The lessor may also undertake to replace the equipment in the event of a serious or prolonged breakdown. In the case of a building, the lessor is responsible for the structural integrity of the building and for replacement in the case of damage due to a natural disaster, for example, and is usually responsible for ensuring that elevators, heating and ventilation systems function adequately.

15.12 Operating leasing developed originally to meet the needs of users who require certain types of equipment only at regular intervals. Many operating leases are for short periods though the lessee may renew the lease when the period expires and the same user may use the same piece of equipment on several occasions. However, with the evolution of increasingly complicated types of machinery, especially in the electronics field, the servicing and back-up facilities provided by a lessor are important factors that may influence a user to lease rather than purchase. Other factors that may persuade users to lease over long periods rather than purchase are the consequences for the enterprise's balance sheet, cash flow or tax liability.

### **Financial leases**

15.13 *Definition:* a financial lease is one where the lessor is the legal owner of an asset but the lessee is the economic owner as the latter bears the operating risks and receives the economic benefits from using the asset in a productive activity. In return, the lessor accepts another package of risks and rewards from the lessee, in the form of repayments associated with a loan. It is frequently the case that the lessor, though the legal owner of the asset, never takes physical delivery of the asset but consents to its delivery directly to the lessee. One indicator of a financial lease is that it is the responsibility of the economic owner to provide any necessary repair and maintenance of the asset.

- 15.14 Under a financial lease, the legal owner is shown as issuing a loan to the lessee, which the lessee uses to acquire the asset. Thereafter the asset is shown on the balance sheet of the lessee and not the lessor; the corresponding loan is shown as an asset of the lessor and a liability of the lessee. Payments under a financial lease are treated not as rentals but as the payment of interest and repayment of principal on the imputed loan. If the lessor is a financial intermediary, part of the payment is also treated as a service charge (FISIM).
- 15.15 Very often the nature of the asset subject to a financial lease may be quite distinct from the assets used by the lessor in his productive activity, for example a commercial airliner legally owned by a bank but leased to an airline. It makes no economic sense to record either the aircraft or its consumption of fixed capital in the accounts of the bank or to omit them from the accounts of the airline. The device of a financial lease avoids this undesirable form of recording the ownership of the aircraft and the decline in its value while keeping the net worth of both parties correct throughout the length of the lease.

15.16 It is common for a financial lease period to be for the whole of the economic life of the asset. When this occurs, the value of the imputed loan corresponds to the present value of the payments to be made under the lease agreement. This value will cover the cost of the asset and usually also include a fee charged by the lessor, which is accrued over the period of the lease. Payments made regularly to the lessor can be recorded as four components: interest payments, repayments of principal on the imputed loan, the lessor fee, and FISIM (if the lessor is a financial intermediary). If the terms of the agreement do not specify how the first three elements are identified, the repayment of principal must correspond to the decline in the value of the asset (the consumption of fixed capital), the interest payable must correspond to the return to capital on the asset and the service charge to the difference between the total amount payable and those two elements.

15.17 A financial lease may also exist when the lease period is less than the economic life of the asset. In this case, the value of the imputed loan again covers the cost of the asset and the fee charged by the lessor plus the value of the service charges to be made under the terms of the lease. Payments made regularly to the lessor shall be recorded as interest payments and repayments of principal on the imputed loan, the lessor fee, and for FISIM (if the lessor is a financial intermediary). It may also include pre-payments funding the repurchase of the asset at the end of the lease period. At the end of the lease, the asset may transfer to the balance sheet of the lessee, depending upon the contractual arrangements. The value of the residual amounts outstanding on the loan will be equal to the expected market value of the asset at the end of the lease period as determined at the start of the lease. At this point, the asset could be returned to the lessor, an option invoked for the lessee to legally acquire the asset, or a new lease arrangement set up.

A financial lease requires the lessee to bear the risks and rewards associated with using the asset. Therefore, any holding gains and losses on the expected value of the asset at the end of the lease period shall be borne by the lessee. In this case, where the asset is legally acquired by the lessee at the end of the lease period, then the cash payments are recorded as the repayment of the loan since the asset is already on the balance sheet of the lessee.

If the asset reverts to the lessor, then a transaction representing the purchase of the asset is recorded at the current market value of the asset. The proceeds are used to repay the amount outstanding on the loan and any difference between those amounts is recorded as a capital transfer. The payments over the lease period will often include pre-payments of the acquisition of the asset so that the transaction occurs for no cash consideration, since the loan is fully repaid at this time.

If a further lease period is negotiated, then the new contract needs to be analysed to see whether it is a continuation of a financial lease or an operating lease.

- 15.18 Although a financial lease will typically be for several years, the duration of the lease does not determine whether the lease is to be regarded as an operating or financial lease. In some cases the asset may be leased for a short period, perhaps only one year at a time, but the contract includes the condition that the lessee takes all responsibility for the asset, including all maintenance and cover for exceptional damage. Even though the lease period is short, and even though the lessor may not be a financial institution, if the lessee accepts the majority of the risks associated with the use of the asset in production as well as the rewards, the lease is recorded as a financial and not an operating lease. However, in practice, it is difficult to deviate from the recording in the business accounts, which follows international business accounting standards, where financial leases are limited to leases covering the major part of the economic life time of the asset.
- 15.19 Any corporation that specialises in financial leasing, even if called a property company or aircraft leasing company, shall be classified as a financial intermediary offering loans to the units leasing assets from them. If the lessor is not a financial intermediary, the payments associated with the imputed loan are split into repayments of principal and interest only; if the lessor is a financial corporation, a further component representing the service charge (FISIM) is included.

15.20 Hire purchase is a type of financial leasing.

*Definition:* a hire purchase arrangement exists when a durable good is sold to a purchaser in return for agreed future payments. The buyer takes possession of the good immediately, though legally it remains the property of the lessor as collateral/guarantee until all agreed payments have been made by the lessee.

15.21 Hire purchase is usually restricted to consumer durables, and most purchasers are in the households sector. Financiers of hire purchase contracts typically are separate institutional units operating in close cooperation with sellers of durable goods

15.22 In the case of hire purchase, the durable good is recorded as if acquired by the purchaser on the day they take possession of the asset at the market price that would have been realised in an equivalent transaction. The purchaser receives an imputed loan of equivalent value. The payments from purchaser to financier are recorded as repayments of principal and interest payments, using the same method as the one applied for financial leasing. The productive activity carried out by financiers of hire purchase contracts is financial intermediation. As they do not usually charge directly for their services, their entire output are FISIM, calculated as property income receivable less interest payable. As in the case of conventional financial leasing, the amount of interest payable may be difficult to observe and must therefore be estimated.



## **Resource leases**

- 15.23 *Definition:* a resource lease is one where the owner of a natural resource makes it available to a lessee in return for a payment recorded as rent.
- 15.24 In a resource lease, the resource asset remains on the balance sheet of the lessor even though it is used by the lessee. Any decline in value of a natural resource is recorded as an economic disappearance of non-produced assets (under K.21, 'depletion of natural resources'). It is not recorded as a transaction similar to consumption of fixed capital, as there is no fixed capital to consume. Payables due under a resource lease, and only such payables, are recorded as rent.
- 15.25 The classic case of an asset subject to a resource lease is land. However, the use of other natural resources is similarly recorded in this way, e.g. timber, fish, water, mineral resources and radio spectra.

## **Permits to use a natural resource**

- 15.26 Permits to use a natural resource can be issued by government, but can also be issued by private owners, like farmers and businesses.

15.27 When permits are issued for using a natural resource, three recording options can be distinguished (see Table 15.3):

- (a) the owner can extend or withhold permission to continued use of the asset from one lease period to the next;
- (b) the owner may allow the resource asset to be used for an extended period of time in such a way that in effect the user controls the use of the resource during this time with little, if any, intervention from the owner;
- (c) the owner permits the resource asset to be used to extinction.

The first option is recorded as a resource lease; this should be recorded as rent.

The second option may not only lead to a recording of rent but also to the creation of an asset for the user, distinct from the resource itself but where the value of the resource asset and the asset allowing use of it are linked.

This asset (category AN.222) is only recognised if its value, the benefits to the holder in excess of the value accruing to the issuer, is realisable through transferring the asset. Such permits are first observed through economic appearance of assets (category K.1, see point (g) of paragraph 6.06). If the value of the asset is not realised it will tend towards zero as the lease period ends.

The third option results in the sale (or possibly an expropriation) of the natural resource itself.

**Table 15.3 — The recording of three different types of permits for the use of natural resources**

Type of use	Method of recording
Permission for temporary use, possibly for a long time	Resource lease: rent (property income)
Control by user during an extended period, risks and rewards borne by the user, transferability of permit at a realisable value	Rent and creation of new asset for the right to use the natural resource
Use to extinction; permanent use (all risks and rewards borne by the user)	Sale of natural resource

- 15.28 In order to distinguish between rent, creation of a new asset and sale of the natural resource, the major criterion is the transfer of risks and rewards. The natural resource is sold if all the risks and rewards have been transferred. A new asset is created if the transfer of risks and rewards results in a separate and transferable permit with a realisable value. Using other criteria, like pre-agreement on payments, up-front payment, length of the permit and treatment in the business accounts, can be misleading as they do not necessarily reflect the transfer of risks and rewards.
- 15.29 Natural resources, like land and mineral resources, may be acquired by non-residents. However, sale of natural resources is not to be recorded as being sold to a non-resident unit. In such cases a notional resident unit is created that holds the title to the natural resource; the non-resident unit then owns the equity of the notional resident unit. A similar recording applies in the case of the acquisition by residents of natural resources in the rest of world.
- 15.30 The revenues of the government from a specific type of natural resources (e.g. revenues from oil and natural gas) can consist of a wide range of transactions. Examples are:
- (a) rent in case of resource leases;

- (b) disposition of non-produced assets, e.g. sales of natural resources or sales of licences for exploiting during an extended period of time;
- (c) dividend from a public corporation exploiting natural resources;
- (d) corporation tax paid by corporations exploiting natural resources.

**Permits to undertake specific activities**

15.31 In addition to licences and leases to use an asset, permission may be granted to engage in a particular activity, quite independently of any assets involved in the activity. The permits are not dependent on qualifying criteria (such as passing an examination to qualify for permission to drive a car) but are designed to limit the number of individual units entitled to engage in the activity. Such permits may be issued by government or by private institutional units and different treatments apply to the two cases.

**Table 15.4 — The recording of the use and purchase of non-financial assets,  
by type of transaction and flow**

Type of transaction	Type of use/purchase and type of asset and type of payment
Intermediate consumption	Operating lease of produced assets, e.g. machines and intellectual property rights  Regular payments by corporations for the delivery of water  FISIM services related to the provision of a financial lease
Consumption of fixed capital	Only for produced assets, and for the economic owner
Final consumption expenditure	Operating lease of consumer durables  Purchase of consumer durables, including when financed by a financial lease, or through a hire purchase agreement
Purchase of non-financial assets	
Fixed capital formation	Purchase of produced assets (including when financed via a financial lease)
Acquisition of natural resources	Purchase of a natural resource including the right to use to extinction  Purchase of the right to use a natural resource for an extended period e.g. a fishing quota
Acquisition of other non-produced assets	Transferable time-share arrangements  Purchase of a contract transferable to a third party  Contracts for future production, for example contracts with footballers and writers

Type of transaction	Type of use/purchase and type of asset and type of payment
Payment as property income	Resource lease, i.e. payment for short-term use of natural resource
Rent	Regular payments for the right to extract water
	Financial lease, i.e. purchase of a non-financial asset financed simultaneously by a loan
Income transfer	Permits issued by government to undertake a specific activity not dependent on qualifying criteria, or with a disproportionate charge compared to the costs of administering the permit scheme
	Emission permits issued by the government to control total emissions
Other taxes on production	
Financial transaction: loan	Financial lease, i.e. purchase of a non-financial asset financed simultaneously by a loan
Other change in volume of assets	Exhaustion of natural resources by the owner
	Illegal logging, fishing or hunting (uncompensated seizure of cultivated assets or natural resources)
Change in the price of assets	Expiry of contracts, licences and permits recorded as assets

- 15.32 When governments restrict the number of cars entitled to operate as taxis or limit the number of casinos by issuing permits, for example, they are in effect creating monopoly profits for the approved operators and recovering some of the profits as the fee. Such fees are recorded as other taxes. This principle applies to all cases where government issues permits to limit the number of units operating in a particular field where the limit is fixed arbitrarily and is not dependent only on qualifying criteria.
- 15.33 In principle, if the permit is valid for several years, the payment shall be recorded on an accrual basis with another account receivable or payable entry for the amount of the permit fee covering future years.
- 15.34 The incentive to acquire such a permit is that the permit holder believes that he will thereby acquire the right to make monopoly profits through the future income being greater than the payments to acquire the rights to them. The benefit to the holder in excess of the value accruing to the issuer is treated as an asset if the permit holder can realise this by transferring the asset. The type of asset is described as a permit to undertake specific activities (AN.223).
- 15.35 The permit to undertake specific activities as an asset first appears in the other changes in the volume of assets account. Changes in value, both up and down, are recorded in the revaluation account.



- 15.36 The value of the permit as an asset is determined by the value at which it can be sold or, if no such figure is available, is estimated as the present value of the future stream of monopoly profits. If the permit is on-sold, the new owner assumes the right to receive a refund from the government if the permit is cancelled as well as the right to earn the monopoly profits.
- 15.37 A permit issued by government to undertake a specific activity is treated as an asset only when all the following conditions are satisfied:
- (a) the activity concerned does not utilise an asset belonging to government; if it does, the permission to use the asset is treated as an operating lease, a financial lease, a resource lease or possibly the acquisition of an asset representing permission to use the asset at the discretion of the licensee over an extended period;
  - (b) the permit is not issued subject to a qualifying criterion; such permits are treated as either taxes or payments for services;
  - (c) the number of permits is limited and so allows the holder to make monopoly profits when undertaking the activity concerned;
  - (d) the permit holder must be able to sell the permit to a third party.

If any of the conditions is not satisfied, the payments are treated as taxes or as payments for services.

- 15.38 For units other than government, it is much less common to be able to limit the participation in a given activity. One instance is when it is either compulsory or desirable to belong to a professional association and there is a strict limit on numbers participating. An example is where an owner of property limits the number of units operating on his property, e.g. a hotel with a policy of only allowing one taxi firm to pick up guests. In these sorts of cases, the permits are treated as payments for services. In principle the payment shall be recorded on an accrual basis throughout the period for which the permit is valid. There is no reason in principle why such permits could not be treated as assets if they were marketable though this may not be a common situation.
- 15.39 A permit issued by a unit other than government to undertake a specific activity is treated as an asset only when all the following conditions are satisfied:
- (a) the activity concerned does not utilise an asset belonging to the permit issuer; if it does, the permission to use the asset is treated as an operating lease, a financial lease or a resource lease;

- (b) the number of permits is limited and so allows the holder to make monopoly profits when undertaking the activity concerned;
- (c) the permit holder must be legally and practically able to sell the permit to a third party.

If any of the conditions are not satisfied, the payments are recorded as payments for a service.

15.40 Governments issue emission permits to control total emissions. Such permits do not involve the use of a natural asset, as no value is placed on the atmosphere, so it is not an economic asset and the permit fees are therefore classified as taxes. The permits are tradable and there will be an active market in them. The permits therefore constitute assets and shall be valued at the market price for which they can be sold.

## **Public-private partnerships (PPPS)**

15.41 Public-private partnerships (PPPs) are long-term contracts between two units, whereby one unit acquires or builds an asset or set of assets, operates it for a period and then hands the asset over to a second unit. Such arrangements are usually between a private enterprise and government but other combinations are possible, with a public corporation as either party or a private NPI as the second party.

Governments engage in PPPs for a variety of reasons, such as the hope that private managements will lead to more efficient production and that access to a broader range of financial sources can be obtained and the wish to reduce government debt.

In the contract period the PPP contractor has the legal ownership. Once the contract period is over, the government has both economic and legal ownership.

More details about the treatment of PPPs are provided in Chapter 20 (government accounts).

## **Service concession contracts**

15.42 Service concession contracts provide a company the exclusive right to provide certain services. For example, in case of a public service concession, a private company enters into an agreement with the government to have the exclusive right to operate, maintain and carry out investment in a public utility (such as a water supply system or a toll highway) for a given number of years. Service concession contracts shall not be recorded as assets where they are not transferable or no value can be realised through transferring them.

## **Marketable operating leases (AN.221)**

15.43 Marketable operating leases are third-party property rights relating to non-financial assets other than natural resources. The lease should confer economic benefits to the holder in excess of the fees payable and the holder should be able to realise those benefits through transferring them. The value of the lease is the benefit to the holder in excess of the value accruing to the issuer. Marketing operating leases can include all kinds of rental and operating lease contracts. For example, a tenant can sublet an apartment to a third party.

## **Entitlements to future goods and services on an exclusive basis (AN.224)**

15.44 Contracts for future production may also give rise to third-party property rights assets. The value of such contracts is the benefit to the holder in excess of the value accruing to the issuer. Examples are:

- (a) exclusive rights to have a person work for them (e.g. football players) or to publish literary works or musical performances. The value of such rights is the profit that can be made on transferring the rights above the costs of cancelling the existing contract;
- (b) time share arrangements. Only part of the time share arrangements has to be regarded as the acquisition of an asset:
  - (1) if the owner has a nominated space, available in perpetuity, is eligible to act as part of the management committee for the scheme, or can sell or bequeath the allocation at will, then the arrangement is most likely to be an asset of the same type as a house;

- (2) if the owner has a fixed agreement to have some form of accommodation available at a given period for a fixed length of time, it is likely that this represents a pre-paid lease, i.e. pre-paid final consumption expenditure by households;
  - (3) this pre-paid lease could be sublet occasionally or sold for the rest of the period of the lease as a transferable operating lease;
  - (4) a participant in a points-based scheme may have an account that is receivable only by way of an asset.
-