

Document Information

Title	Policy paper – Leases
Author	IPSAS policy team
Owner	OFA
Document type	POLICY PAPER
Status	Final
Location	

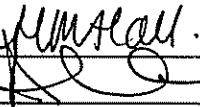
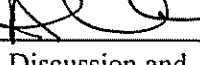
History

Version	Date	Author	Description
1.0	06/01/2010	JPD	Draft version
2.0	07/06/2010	JPD	Modified after review by Helen Hall, George Kyriacou
3.0	31/07/2010		Finalized
4.0			
5.0			
6.0			

Review process

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OFA	Darshak Shah		15/12/2011	
UNBOA	UNBOA	Discussion and review only		

Distribution

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I. IPSAS 13 leases

Finance lease – Operating lease

Definition

IPSAS 13 differentiates finance leases and operating leases:

- A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
- An operating lease is a lease other than a finance lease.

The classification of a lease between operating lease and finance lease is important as accounting methods are different. A finance lease is considered as a fixed assets and a liability is also recorded. An operating lease is not considered as a fixed asset and payments to lessor are accounted for as a rent.

IPSAS 13 requires entities to examine the substance of the transaction rather than the form of the contract and provides examples of criteria that would normally lead to a lease classified as a finance lease:

- IPSAS 13 paragraph 15:
 - a. The lease transfers ownership of the asset to the lessee by the end of the lease term;
 - b. The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
 - c. The lease term is for the major part of the economic life of the asset even if title is not transferred;
 - d. At the inception of the lease¹ the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;
 - e. The leased assets are of such a specialized nature that only the lessee can use them without major modifications;
- IPSAS 13 paragraph 16:
 - f. The leased assets cannot easily be replaced by another asset.
 - g. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
 - h. Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease);
 - i. The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

¹ Lease classification is made at the inception of the lease. changes in estimates (for example, changes in estimates of the economic life or the residual value of the leased property) or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes

Under US accounting standards, a finance (capital) lease is a lease which meets at least one of the following criteria:

- Ownership of the asset is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option to buy the equipment at less than fair market value;
- The lease term equals or exceeds 75% of the asset's estimated useful life;
- The present value of the lease payments equals or exceeds 90% of the total original cost of the equipment.

IFRS avoids the "bright line" tests (specifying an exact percentage as a limit) on the lease term and present value of the rents. Instead, IAS 17 has the following five tests. If any of these tests are met, the lease is considered a finance lease:

- Ownership of the asset is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option to buy the equipment at less than fair market value;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Exceptions in IPSAS 13

IPSAS 13 paragraph 17 states that "the examples and indicators [...] are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease.

As a consequence, the classification as a finance lease is not as automatic as in US GAAP and IFRS. If the indicators in paragraphs 15 and 16 lead to a financial lease, the substance of the contract has to be further analyzed in order to conclude to a finance lease. It is then necessary to determine if the risks and rewards have substantially been transferred.

This analysis requires exercising professional judgement with IPSAS not providing detailed guidance on risks and rewards. The only reference in IPSAS 13 is paragraph 12: *"risks include the possibilities of losses from idle capacity, technological obsolescence or changes in value because of changing economic conditions. Rewards may be represented by expectation of service potential or profitable operation over the asset's economic life and of gain from appreciation in value or realization of a residual value"*.

Sub lease (lessor)

Note that with IPSAS 13 paragraph 24 and in accordance with IPSAS 16, it is possible for a lessee to classify a property interest held under an operating lease as an investment property [...]. This will be the case if the lessee Grants a sublease that transfers substantially all of the risks and rewards incidental to ownership of the interest to an unrelated third

party. Such a sublease is accounted for by the lessee as a finance lease to the third party, although it may be accounted for as an operating lease by the third party.

IPSAS 13 is not requiring entities to disclose those leases as investment properties but offers the possibility. This is an option that UNDP might want to exercise.

II. UNDP lease analysis

Commercial lease

Compliance with IPSAS

According to IPSAS, a lease is *"an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time"*. This definition shows that a lease in IPSAS requires series of payments to the lessor.

A commercial lease is an exchange contract between UNDP and a private company. In exchange of the usage of the asset, the lessor receives a payment or series of payments. Commercial lease is contracted for office space and in certain cases equipments.

Commercial lease qualify with definition of a lease and IPSAS 13 is applicable. If the lease agreement qualifies with a finance lease, then UNDP has to recognize an asset and a liability:

- The asset represents the right to use the asset during the lease term
- The liability represents the minimum lease payments UNDP has to pay to the lessor

Key concepts

Inception of lease

According to IPSAS, The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date: (a) A lease is classified as either an operating or a finance lease; and (b) In the case of a finance lease, the amounts to be recognized at the commencement of the lease term are determined. For the opening balance, it is important to make a decision on lease as if the accounting treatment is determined at the inception of the lease. This aspect is important because the lease term is also determined at the inception of lease.

Lease term

According to IPSAS, the lease term is different from the total lease duration. The lease term is the non-cancelable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

With IPSAS 13, the lease term is, then, the primary non-cancellable period of the lease together with any secondary periods during which the lessee has the contractual right to continue to use the asset and which right, at the start of the lease, it is reasonable to expect him to exercise. For

example, UNDP can have a lease term of 5 years but practically stay in a building during 20 years. It is important to consider the lease term at the inception of the lease,

Also note that US GAAP gives also some benchmark for determining the lease term. For example, FASB statement NO 13, Accounting for leases, indicates that a renewal period is reasonably assured, and should be considered part of the lease term, when failure to renew a lease imposes a penalty on the lessee.

Finally, we would like also to mention that IPSAS 13 paragraph 44 requires disclosing "*the total of future minimum lease payments under non-cancellable operating leases*". Note that IPSAS 13 is then doing a clear distinction between cancellable and non-cancellable leases.

Lease agreements, entered into by UNDP, normally have 30 days non-cancellable period. The purpose to have this short non-cancellable period is to mitigate the exit risks which may result from a) the nature of UNDP's operations in terms of development project work in politically unstable situations b) security concerns c) the duration of the projects and d) the intended period of stay. Hence, this 30 days non-cancellable period gives UNDP ability to respond quickly to political unrest or uncertainty, security issues, etc. While analysing a lease to determine if it is finance or operating lease, all these factors, together with the criteria listed in IPSAS 13 paragraphs 15 and 16, are needed to be taken into consideration at the inception of the lease.

Minimum lease payments

Minimum lease payments are the payments over the lease term that the lessee is, or can be, required to make, excluding contingent rent, costs for services and, where appropriate, taxes to be paid by and reimbursed to the lessor [...] if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it. The payment plan is determined according to the lease term (and not for the total lease duration). The minimum lease payments show the lessee liability.

Other issues

- Sub-leasing (UNDP lessee). In some circumstances, UNDP is not the primary contractor to a lease and contract a sub-lease. It happens when a UN agency leases an office space and sub lease a floor to UNDP. In exchange of the usage of the asset, the UN agency receives a payment or series of payments from UNDP. Those contracts generally qualify as operating leases in IPSAS 13 as there is no substantial transfer of risks and rewards.
- Sub-let (UNDP lessor). In other circumstances, UNDP is the primary contractor to a lease and sub-lease to other UN agencies. In exchange of the usage of the asset, the UN agency sends a payment or series of payments to UNDP. Those contracts qualify as leases in IPSAS 13 (lessor).

Government lease

Compliance with IPSAS

At UNDP, we can find two forms of government leases:

- SBAAs countries leases. According to SBAA and as counterpart of UNDP involvement, the recipient government has to provide UNDP *"an appropriate office with equipment and supplies, adequate to serve as local headquarters for the UNDP in the country"* and *"the government shall have the option of providing in kind the facilities [...]"*. When recipient government chooses to provide in kind the facilities, an agreement between the government and UNDP is signed. The facilities are provided with a free rent. The duration can vary.
- Other government leases. In some circumstances, UNDP receives the right to use an asset at no cost and without counterpart. It will be the case for example of the free rent leases provided by the German government (UNV premises) or the Danish government (Copenhagen premises) to UNDP.

Under those agreements, there is no transfer of cash between the lessee and the lessor, suggesting that IPSAS 13 is not applicable. IPSAS 23 revenue from non exchange transactions should be the standard applicable to those transactions. However, IPSAS 23 is providing guidance on donations (transfer of the asset) but not on the "right to use an asset".

UN task force analysis

The UN task force has tried to cover this issue in the paper "control over assets". Paragraphs 39 and 40 are related to the "donated use of a building" and UN task force reaches the following conclusion: *"The organization controls the building and should include it as an asset on its statement of financial position. This conclusion can be reached either through direct application of the definition of control, application of IPSAS 13 'in-substance ownership/control' principles by analogy (the issue is not within the scope of IPSAS 13, because no lease payments are made) or through reference to guidance available from jurisdictions where public sector entities apply IPSAS-similar concepts and standards and have encountered similar donated use of building situations."* This analysis is interesting but is not providing a practical guidance. Several questions can be raised: How to value the right to use? lease term? Fair value of the building? What about the revenue recognition? Recognition in full upfront? When the right to use is "consumed"?

UNDP analysis

As there is no specific standard for leases from non-exchange transactions, we can consider that both IPSAS 13 and IPSAS 23 are relevant to analyze government leases. First, the lease agreement should be analyzed according to IPSAS 13 Leases:

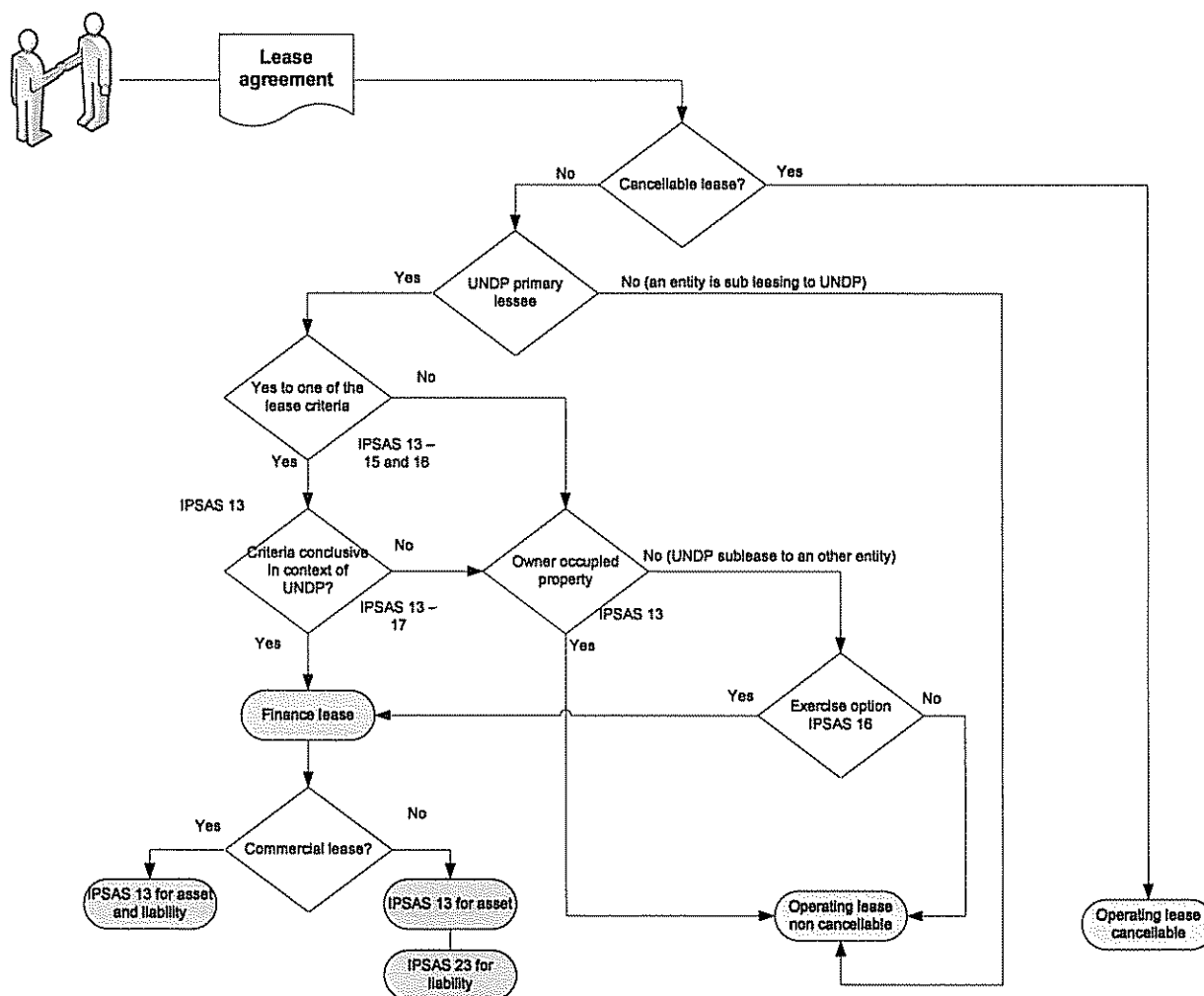
- Is the agreement an operating lease or a finance lease? IPSAS 13 indicators together with UNDP specific factors (already discussed in the section "Commercial Lease- lease term") are applied to the lease agreement. It is then necessary to determine what is the lease term, to estimate the lease payments (benchmark with similar commercial leases), the fair value of the building, etc. For government leases in SBAA countries, the estimation of lease payments is already included in the GLOC target.

- If the analysis concludes to an operating lease, then no right to use is recorded on the balance sheet. However, UNDP has to consider opportunity to record in its books two transactions: the lease expense and the contributions from government.
- If the analysis concludes to a finance lease, then the estimated lease payment (benchmark with similar commercial lease) is used to determine the value of the right to use (minimum of fair value and lease payments).
- In a finance lease, UNDP has to recognize an obligation (liability) for the lease payments. As, no payment is involved in the transaction, IPSAS 23 is applicable to this part of the finance lease. According to IPSAS 23, UNDP has to determine if the contract includes conditions that restrict the revenue recognition (for example, UNDP presence in the recipient Country).

III. UNDP cases study

UNDP lease decision trees

Finance lease vs operating lease



Application of the decision tree

We have reviewed a sample of lease contracts signed by Country Offices and applied IPSAS 13 lease conditions. The result of the analysis is summarized in the table below:

Lease conditions	Point E (Senegal)	Malawi lease	Kyrgyz republic
IPSAS 13 lease conditions			
The lease transfers ownership of the asset to the lessee by the end of the lease term;	No	No	No
The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;	No	No	No
The lease term is for the major part of the economic life of the asset even if title is not transferred;	No	No	No
At the inception of the lease ² the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;	No	No	No
The leased assets are of such a specialized nature that only the lessee can use them without major modifications;	No	No	No
The leased assets cannot easily be replaced by another asset.	No	No	No
If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;	No	No	No
Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease);	No	No	No
The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.	No	No	No

Commercial lease Senegal

If we apply strictly the conditions listed in IPSAS 13, the lease qualifies as an operating lease:

- According to Senegal laws (OHADA), the lease has an indefinite term. However, the analysis of the law shows that the non-cancellable period is 2 years. If we take the assumption that at the inception of lease, UNDP will exercise the renewal option, the lease term is 4 years. UNDP is renting a building in good conditions. We can assume that the economic life of the building is greater than 4 years
- The net present value has been estimated with the assumption that the lease term is 4 years. The fair value has been estimated by multiplying the number of square meters

² Lease classification is made at the inception of the lease. changes in estimates (for example, changes in estimates of the economic life or the residual value of the leased property) or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

and the market value per square meters (Real estate market in Dakar). The interest rate used is 5%, our benchmark is the ASHI actuarial valuation (less 1% to be prudent). The result shows that the net present value is inferior to the fair value of the building.

The Senegal agreement is an example but we can expect that most of the commercial lease will fall under the operating lease category.

Government lease SBAA Malawi

If we apply strictly the conditions listed in IPSAS 13, the lease qualifies as an operating lease:

- The lease agreement paragraph 2 states that *"the premises shall be placed at the disposal of the UNDP with effect 1 January 2005 and they shall continue to inure the benefit of the UNDP until 31 December 2010"* and paragraph 3 *"it is understood that the UNDP may terminate this agreement at any time upon giving notice to the government not less than 30 days before such termination. This agreement shall be terminated without prejudice to any existing claims"*. According to those paragraphs, the non-cancellable period is 30 days. No renewal period is mentioned. 30 days will always be inferior to the economic life of a building.
- With a lease term of 30 days, the net present value cannot reach 90% of the fair value of the building. The net present value is inferior to the fair value of the building. The lease can be defined as a cancellable lease.

Government lease SBAA Kyrgyz

If we apply strictly the conditions listed in IPSAS 13, the lease qualifies as an operating lease:

- The lease agreement is established for a period of 30 years with an option to extend the term as long as UNDP is present in the Kyrgyz Republic. However, paragraph 3 also mentions that UNDP may terminate the agreement at any time this agreement at any time upon giving notice to the government not less than 30 days before such termination. This agreement shall be terminated without prejudice to any existing claims. A renewal period is mentioned but the renewal is not enforceable to UNDP. According to those paragraphs, the non-cancellable period is 30 days. 30 days will always be inferior to the economic life of a building.
- With a lease term of 30 days, the net present value cannot reach 90% of the fair value of the building. The net present value is inferior to the fair value of the building. The lease can be defined as a cancellable lease.

IV. Conclusion

Finance leases

Based on the analysis provided above, our professional judgment is that for Country Offices and Project Offices, the expected lease term for both commercial leases and government leases, at the inception of lease, is in substance rarely for the major part of the economic life of the fixed asset and the net present value is rarely superior to the asset fair value. It is then expected that most of the lease contracts are cancellable (to provide UNDP flexibility to respond to exit risks discussed earlier) and will only qualify as operating leases. However, the classification of lease contract has to be done on a case by case basis and it is not possible to define an accounting treatment by category of lease agreements. We can only expect that UNDP exposure to finance lease will be limited to exceptional cases.