Leasing Guidelines

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Government of South Australia
Department of Treasury and Finance

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Content

1 Introduction

Leasing can provide a cost-effective means for agencies to acquire assets used to provide services to the public. Although leasing is a potentially valuable procurement option, it is nevertheless essential that agencies are aware of the risks and benefits that arise when entering into lease contracts.

A lease is essentially a contract by which the owner of an asset allows another party to use the asset for a defined period, in return for an agreed payment. Lease contracts, however, are often complex agreements that may result in the owner gaining a significant financial advantage, a result that usually arises through inadequate analysis of the total costs and risks of the lease and management of the lease contract.

Failure to achieve the most cost-effective outcome when procuring assets, either directly or through leasing arrangements is usually a result of a misunderstanding of the following issues:

- the effective, or whole-of-life, cost of leasing compared with the direct purchase of assets, or vice versa;
- the impact of lease terms and conditions that can increase the cost of using the asset, including restricting the use of the asset compared to its intended use;
- the differences between operating and finance leases and the impact of the risks implicit in either lease;
- allowing lease payments (ie returns to the owner) that are excessive relative to the apportionment of risks in the lease agreement;
- failure to ensure that leased assets are acquired through an effective competitive process;
- the need for ongoing management of lease contracts; and
- the occurrence of hidden costs through lack of compliance with lease terms, particularly asset maintenance provisions.

In view of these risks, public sector agencies can benefit substantially from the application of uniform leasing guidelines when contemplating procurement by a leasing arrangement.

1.1 Objectives

The objectives of these Guidelines are to:

- ensure that the Government receives value for money when acquiring assets by conducting a thorough evaluation of the effective cost of leasing relative to direct purchase;
- enable agencies to assess the risks inherent in leasing arrangements to ensure that the cost of the lease adequately reflects the material risks carried by the parties to the lease agreement; and
- ensure that leases are properly costed to reflect whole-of-life procurement costs, having regard to the risks and benefits provided by the leasing arrangement.

South Australian Government agencies are expected to follow these principles as closely as possible when contemplating the acquisition of assets by means of a leasing arrangement.

1.2 Scope

The Leasing Guidelines are to apply when contemplating procurement via a leasing arrangement where the cost of the asset or group of assets to be acquired and/or the present value of the proposed lease payments exceeds $100,000. On 11 October 2004, Cabinet mandated SAFA's services including the requirement that SAFA be consulted for all leasing transactions with a present value of lease payments exceeding $100,000. However, it is recommended a basic 'lease versus buy' analysis be undertaken before entering any leasing agreement.

The Leasing Guidelines assume that compliance with the necessary processes and approvals, including Treasurer's Instruction 8, *Expenditure for Supply Operations, and other Goods and Services*, Treasurer's Instruction 20, *Guarantees and Indemnities* and for proclaimed semi-government authorities, the *Public Finance and Audit Act 1987*, has occurred in the decision being made to acquire the asset. Having fulfilled the necessary requirements in order to acquire the asset, the Leasing Guidelines address the question of whether leasing is the most cost-effective means of financing the acquisition of the asset.

These Guidelines do not apply to office accommodation and fit out costs, which are covered by Department of Premier and Cabinet Circular 18 – *Government Office Accommodation Framework*.

The South Australian Government Financing Authority (SAFA), in conjunction with the Department of Treasury and Finance (DTF), has developed these Guidelines. SAFA provides a comprehensive advisory service relating to leasing and financing including software to assist agencies in the 'lease versus buy' analysis.

1.3 Queries or assistance

Any queries on these Guidelines or technical assistance on leasing and financing issues can be directed in the first instance to SAFA Client Services on 8226 9441.

Depending on the nature of the issue, advice is also available from:

Crown Law — Chris Gray (82071539)

Department of Planning, Transport and Infrastructure (DPTI) — Helen Thornton (8226 5852)

DTF — Financial Management Team (8226 1786)

2 Leasing principles

2.1 What is a lease?

The Australian Accounting Standards Board in AASB 117 *Leases* (AASB 117) defines a lease as follows:

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.

The definition of a lease includes contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

The owner/financier of the asset is frequently referred to as the lessor and the user of the asset as the lessee.

2.2 Transfer of risk

The private sector generally cannot raise capital at rates as favourable as the State Government. However, the fact that the Government's cost of finance is lower than the private sector does not necessarily mean that all assets should be purchased directly, as the financial risks associated with the asset over the term of its useful life may be considerable. The realisation of the risks associated with the asset may increase the effective cost to the Government to the extent that it may be more efficient to consider leasing the asset from a private supplier.

Consideration must therefore be given to the risk of the asset itself and the degree of risk that can be transferred by means of a lease agreement. These factors are used to determine whether the premium (if any) embodied in the lease payment is justifiable on commercial grounds and whether the arrangement is beneficial to the State.

Different types of leases have different risk profiles, which will affect the risk premium over the Government's nominal borrowing cost that the lessor will require as compensation for accepting these risks.

The extent to which risks and rewards incidental to ownership are transferred from the lessor to the lessee will determine the classification of a lease.

The accounting standards require the classification of a lease agreement to be made at the inception of the lease and it is the economic substance of the transaction, rather than the legal form of the contract, which determines the lease classification.

2.3 Finance leases

A finance lease is defined in AASB 117 as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee. Title may or may not eventually be transferred.

The following indicators provided in AASB 117 are likely to lead to a lease being classified as a finance lease. Only one of the indicators need apply.

- The lease transfers ownership of the asset to the lessee by the end of the lease term;

- The lessee has the option to purchase the asset at a price which 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 lease term is for the major part[1] of the economic life of the asset even if title is not transferred;

- The leased assets are of a specialised nature (customised asset) that only the lessee can use them without major modifications;

- The present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset[2].

If there is no clarification from the 5 indicators above, AASB 117 provides further indicators of a finance lease that can be used, as follows:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are born by the lessee;

- Gains or losses from fluctuations in the fair value of the residual fall on the lessee;

- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

In a finance lease, the lessor's primary role is a financier. At the end of the lease, the asset is transferred to the lessee for a specified sum, which can often incorporate a (guaranteed) residual value. A finance lease is therefore a loan from the lessor to the lessee.

Because finance leases are in effect borrowings, the *Public Finance and Audit Act 1987* prevents semi-government authorities from entering into finance leases (financial arrangements) without the Treasurer's approval.

In addition, Treasurer's Instruction 20 *Guarantees and Indemnities* requires that public authorities must not give an undertaking that binds the Government without the Treasurer's approval, to:

- purchase, construct or otherwise provide any asset or service for the benefit of any person or organisation where there is no appropriation for such purpose;

- purchase goods or services where there is no appropriation for such purpose; or

- provide a guarantee or indemnity to any person or organisation for the benefit of that person or organisation or other person or organisation.

Even without these legislative constraints, SA Government agencies would not generally enter into finance lease arrangements, as the higher cost of private finance cannot be justified in view of the absence of a genuine transfer of risk to the private supplier. In the absence of risk transfer, it will generally not be possible to justify paying an effective lease rate or interest cost that is higher than the State's cost of borrowing.

2.4 Operating leases

An operating lease is defined in AASB 117 as a lease other than a finance lease, ie the lease agreement does not transfer substantially all the risks and rewards incidental to ownership.

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[1] The market uses 75% as a guide for the 'major part'.

[2] The market uses 90% as a guideline for 'substantially all'.

An operating lease is often referred to as a rental agreement. If the list of circumstances documented in paragraphs 10 to 12 of AASB 117 (indicators of a finance lease) are not met, the lease will be an operating lease.

Indicators of an operating lease are:

- asset ownership remains with the lessor, ie asset ownership has not been transferred to the lessee by the end of the lease term;

- the lease term is considerably shorter than the asset's expected useful life; and

- the lease agreement is cancellable by the lessee at short notice with little or no additional cost or contractual penalty.

Attachment 1 of these guidelines further discusses the classification of leases or further advice can be sought from SAFA Client Services.

Operating leases can be classified as “financial arrangements” under the *Public Finance and Audit Act 1987*, therefore semi-government authorities should seek the Treasurer's approval before entering into an operating lease.

2.5 Accounting treatment

Accounting for leases is dealt with in Accounting Standard AASB 117 *Leases* and Public Authorities that are reporting entities should comply with the requirements of the standard. In general, AASB117 requires that:

- leases be classified as either operating or finance leases at the inception of the lease according to their economic substance rather than the form of the lease agreement;

- lease payments under an operating lease are recognised in the lessee's financial accounts as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit;

- a finance leases is recognised in the lessee's financial accounts as an asset and a liability at the inception of the lease. The asset and liability are measured at the lower of their fair value or the present value of minimum lease payments. The lease asset should be depreciated over its useful life in accordance with AASB116 *Property, Plant and Equipment* and AASB138 *Intangible Assets*. Lease payments should be apportioned between the finance charge and a reduction in the lease liability.

The critical variable in classifying a lease is the extent to which the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Classifying a lease as either operating or financing often requires a professional judgement.

Where there is uncertainty about lease classification of about accounting for leases, further advice should be sought from either SAFA Client Services or the Financial Management Team in DTF.

2.6 Financing decisions and whole of life costing

Leasing, whether a finance lease or an operating lease, is simply an alternative to direct purchase. The preparation of a sound business case for the investment decision to demonstrate the reason for the acquisition must precede the financing decision.

Agencies must also demonstrate that the cost of the lease is within current and projected budgetary parameters and all relevant Treasury guidelines and instructions are complied with.

When making leasing decisions, agencies must satisfy themselves that the most cost-effective financing alternative is adopted. This is not necessarily the lowest cost alternative, as the effective cost of the lease will be determined to a large extent by the degree of risk transferred to the lessor.

The focus of the procurement and financing decisions is to achieve value for money, having regard to both the risks and benefits of acquiring the asset, from a "whole-of-life" perspective.

Agencies should ensure that one or more of the following conditions exist as a prerequisite to entering the leasing arrangement. At a minimum, the lease must meet at least one of the following conditions:

1. provide use of an asset not otherwise available;

2. meet a need for the temporary use of equipment;

3. provide buying and servicing advantages not otherwise obtainable;

4. shift the risks of ownership; and/or

5. realise a quantifiable economic advantage.

Leasing arrangements can have the effect of transforming capital expenditures into recurrent expenditures. From a budget perspective, leases can therefore provide a means to circumvent capital budget constraints. This applies to investment in new assets and the disposal of existing assets via sale-and-lease-back arrangements.

Budgetary constraint considerations should not play a role in lease evaluation. The evaluation of leases centres on delivering a lower whole-of-life cost within a framework that allows for meaningful risk transfer between the parties. Care should be taken to ensure that the whole-of-life cost of leasing is taken into consideration when assessing a lease, rather than simply the lease payments that fall into the current budget period.

Agencies need to ensure that the net present value (NPV) of all operating lease commitments are provided in feasibility studies and business cases and in any reports to DTF.

The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease. If this rate is not practicable to determine, the lessee's incremental borrowing rate shall be used. This can be obtained from SAFA.

Where leases are correctly valued, the cost difference in NPV terms, between leasing and buying, should be limited to the value of the risks and benefits transferred to the private supplier of the leased asset.

2.7 Competitive procurement processes

In general, agencies should assume that proposals for leasing arrangements will be subject to a competitive procurement process, in accordance with Treasurer's Instruction 8, *Expenditure for Supply Operations, and other Goods and, Services*.

When conducting tenders, agencies should also refer to *Contracting Out and Competitive tendering: Guidelines for the Private Sector*, contained within the Prudential Management Group's Project Handbook. This handbook is a useful reference as it consolidates into a single resource, the various Government policies, guidelines and principles that govern contracting out.

In addition, the State Supply Board is able to provide information on the requirements in relation to procurement processes. The Accredited Purchasing Units within your portfolio can also provide advice on governance issues and procurement.

2.8 Taxation issues

The *Income Tax Assessment Act 1936* or *1997* (ITAA) contains several anti-avoidance provisions directed specifically at the leasing arrangements between the private and public sectors. These provisions operate to deny deductions to private sector suppliers where the underlying purpose of the transaction (as determined by the Australian Tax Office) is to reduce the cost of finance through the sharing of the tax benefits between the private and public sector parties to the lease. The ITAA can introduce considerable uncertainty and complexity in the negotiation and structuring of lease arrangements, therefore, it is worthwhile that agencies have a working knowledge of the provisions affecting lease contracts.

Further discussion of the taxation issues relating to leases is provided in Attachment 2.

3 Lease vs Buy analysis

The primary objective of a 'lease versus buy' analysis is to determine whether the total cost, in NPV terms, of entering into a leasing arrangement is lower than the total cost of procuring the asset by outright purchase. In order to make this evaluation, regard must be had to the risk interest within the asset. Exposure to risk increases the effective cost of owning the asset, so that the owner of the asset will require a premium over the risk-free interest rate to compensate for risk.

Ignoring any effect of market distortions such as taxes, transaction costs and different cost of capital rates among competing intermediaries, a lease is equivalent to acquiring assets with 100% debt financing. The difference in the cost of leasing or buying is due to the effective cost of financing the asset, which in the absence of any guarantees by the lessee, is determined entirely by the risk interest within the asset. Lease premiums (over the risk free cost of funds) vary considerably according to the market's perception.

In practice, leasing can be a cheaper option than buying because of the differences in a number of factors, such as tax status, cost of capital or specialisation in risk management and market access amongst intermediaries that may not be available to the public sector.

The section below outlines a general approach for the analysis of leases. The approach assumes familiarity with the techniques in discounted cash flow (DCF) methodology.

Agencies should contact SAFA Client Services if they require assistance with DCF techniques.

The simplest method to analyse a lease is by comparing the NPV of cash flows from leasing with the cash flows from purchasing — the latter is usually just the purchase price less the discounted expected residual value. If the NPV of the cost of leasing is higher, then purchasing (legal ownership) is the better option.

Care must be taken to ensure that different lease proposals are being compared on the same basis.

SAFA's Asset Purchase Financing Evaluation Model is a 'user-friendly' spreadsheet that is complete with detailed explanatory material to enable agencies to readily undertake 'lease versus buy' analysis.

Agencies should contact SAFA Client Services for information about the model.

3.1 Cash flows

It is important to identify all relevant cash flows in a 'lease versus buy' evaluation. In an incremental analysis it is only necessary to identify those cash flows that differ between the two options so as to isolate the additional cost (if any) of leasing over purchasing.

For example, if the asset transfers to the State at the end of the lease, residual ownership does not differ between options and thus, the residual value is excluded from the analysis.

Alternatively, all costs of ownership and leasing can be identified so that a whole-of-life cost of each option is established. This approach is more complex but provides more meaningful results in terms of the overall costs of each option. Both approaches provide equivalent results.

The prime determinants of leasing cash flows are the purchase price, the residual value, maintenance and operational costs and cancellation options. These determinants are discussed below.

Purchase Price

The purchase price will generally represent the single biggest cash flow in a 'lease versus buy' analysis. As such, it is important that it represents the full cost of acquiring and bringing the asset to a fit-for-purpose state to the same extent as would occur under the lease option.

Residual Value

The residual value is also a significant component of a 'lease versus buy' analysis since it helps to offset the cost of the purchase option. It is therefore necessary to reduce the cost of the ownership option by the present value of the asset's worth at termination.

Some finance leases will involve a transfer, for nominal value, at termination of the agreement. In this case, the asset will be owned under both lease and purchase options and the residual value can therefore be excluded.

The residual value is typically the cash flow item exposed to the most risk in the analysis. Indeed, the avoidance of residual or obsolescence risk is often a primary motivation for entering into an operating lease. The appropriate residual value should be carefully determined and the estimate subjected to sensitivity analysis. The impact of residual value on total costs will often be the determining factor of a 'lease versus buy' analysis.

In determining the expected residual value, the costs to sell need to be netted off against expected sale proceeds.

Maintenance

Leasing an asset often involves a transfer of maintenance costs and risk to the lessor. If the arrangement is a maintenance, full service or rental lease, responsibility for maintenance and other costs may rest with the lessor. It is necessary to include maintenance as a cost of ownership in order to assess both the purchase and lease option on a comparable basis. Alternatively, the lease quote can be obtained both including and excluding maintenance.

Cancellation Options

In a strict operating lease, it should always be possible to cancel the lease.

Cancellation options can be valuable as they provide a means of reducing the risks of ownership. This is more important when the asset has a long life or the asset's value is likely to be volatile or uncertain. A detailed discussion of the valuation methodology applied to cancellation options is beyond the scope of these Guidelines and assistance can be sought from SAFA Client Services for the valuation of cancellation options.

Certain leases are only cancellable in particular circumstances, such as:

(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(c) if the lessee enters into a new lease for the same or an equivalent assent with the same lessor; or

(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

Leases that are only cancellable in these circumstances are known as non-cancellable leases.

Discount Rates

Ascertaining the appropriate discount rate for a leasing analysis is an essential component of the assessment.

For the lease rentals which are known with certainty under the lease agreement, the appropriate discount rate is the Government's cost of funds for a loan instrument over the equivalent life of the lease as provided by SAFA.

For the residual value cash flow, it is also recommended that the Government's cost of funds for the relevant term be used as the discount rate in the net present value analysis.

The Leasing Guidelines are based on using nominal discount rates to discount nominal cash flows. If the proposal involves real cash flows (cash flows linked to inflation) then a real discount rate should be used.

SAFA Client Services can provide further assistance on discount rates and valuing cash flows. In particular, it is recommended that where there are concerns about the riskiness of future cash flows, SAFA's advice be sought about valuing such cash flows.

4 Sensitivity analysis

As with all financial evaluations, it is important to test the sensitivity of the result to changes in the key parameters and assumptions used in the analysis. This is particularly important for variables where the outcome is highly uncertain or has the potential to materially affect the lease or buy decision.

The following variables are frequently subject to sensitivity analysis.

4.1 Residual value

Given that the residual value is typically the cash flow item exposed to the most risk in the analysis, it is appropriate to undertake the 'lease versus buy' analysis under a range of residual value outcomes. This is readily facilitated by the spreadsheet provided by SAFA.

Generally, higher residual values favour purchasing rather than leasing. If leasing is preferred, it is useful to ascertain the amount by which the residual value needs to change to make leasing unfavourable.

4.2 Maintenance costs

Where a lease provides for the maintenance of an asset, the ownership case must reflect similar costs or the lease vs buy analysis will be biased against leasing. This is particularly the case for assets with high maintenance costs relative to the leasing costs, where these charges may be volatile.

5 Lease documentation issues

Lessors often attempt to include clauses into lease agreements that mitigate the risk of the lessor or transfer risk to the lessee. The result is that lessors have the potential to either increase the cost of the lease to the lessee, or to restrict the lessee's ability to use the asset to the extent intended. In both cases, value for money is diminished, often severely.

This section presents a series of lease terms and conditions advocated by lease financiers that should be considered very carefully by agencies, with appropriate reference to the Crown Solicitor's office as applicable.

Commencement date and interim rentals

Interim rentals arise when the lease is drawn on a date other than the rental payment date. The lease payment must be adjusted on a pro-rata basis to reflect the interim period. If not adjusted properly, that is, calculated on the number of days from the draw down date to the payment date, interim rentals can significantly reduce the cost effectiveness of the lease.

Inertia rentals

Inertia clauses provide that the lease contract automatically rolls over at termination at full price. The net result is that new equipment prices are being paid for "second-hand" equipment. This can be a highly profitable outcome for the lessor. Inertia clauses are generally not acceptable. If an inertia clause is to be included in the lease contract, the payment terms, which should reflect the depreciated value of the asset at the time, must be expressly stated.

Similarly, some leases provide that the lease must be continued should specified asset returns not be met. This practice is also not acceptable.

End-of-term options

Leases that allow for renegotiation of the payments at a discount are generally not acceptable. Many leases contain extension options at around 80% of the original lease payment. Given that the asset would normally be worth substantially less than this amount, this does not provide value to the agency.

Termination arrangements should provide the option to:

- purchase the equipment at market value;
- renegotiate the lease at reasonable intervals based on market value; or
- have the equipment removed by the lessor.

Furthermore, the lease contract should require the lessor to provide warning of the imminent expiry of the lease.

Note that it is often the actions or omissions of the lessee (or agency) at the end of a lease arrangement that generally determines the overall financial performance of the lease.

Asset upgrades

Lessors can earn windfall profits by "suspending" the lease to upgrade the asset and then reinstate the original lease for an extended term, sometimes at higher interest rates than applied for the original lease. In effect, the "suspension" is a termination of the original lease and the initiation of a new lease, but has a different asset value, capital rate and residual value to the original lease.

Asset upgrading should not be undertaken without a thorough evaluation of the replacement lease on the same basis as the original lease.

Cancellation penalties

A true operating lease should enable the agency to exit the lease should the equipment become either obsolete or surplus to requirements. In cases where the equipment may depreciate more rapidly than the amortisation rate implied by the lease payment, the lessor may incorporate a commercially balanced adjustment due on cancellation. Early cancellation penalties are not acceptable.

Fixed payments

Although common in leases for accommodation, lease arrangements should be fixed such that inflation or interest rate risk is passed to the lessor.

Taxes

Any taxation effects (both State and Commonwealth) that arise as a consequence of differential treatment of public versus private sector entities should be included in the ‘lease versus buy’ analysis, as discussed in the section entitled “Competitive Neutrality”. This specifically includes the application of any stamp duty on the lease to the lessee or the lessor.

Asset management and service bundling

Some lessors attempt to bundle additional services (eg asset maintenance) into lease packages. A third party with whom the agency has no legal relationship often provides these services. The supposed attractiveness of these offers is that the agency makes a single payment for a “package deal”, the cost of these services being implicit in the lease payments.

Asset related services are costs, not benefits. Lessors should be required to provide a breakdown of the lease payments so that the agency can determine the value-for-money of each component. Flexibility should be retained as to whether the agency will accept asset maintenance services from the lessor, a third party of its choice, or be undertaken in-house.

Indemnities

Some lessors attempt to incorporate non-standard indemnities relating to changes in the treatment of the lease for taxation purposes. Changes to tax law are a normal risk incurred as a consequence of doing business and indemnities should not be provided, except in exceptional circumstances.

Treasurer’s Instruction 20 *Guarantees and Indemnities* requires a public authority to obtain the Treasurer’s approval prior to giving an undertaking that binds the Government to provide a guarantee or indemnity.

Managing the lease

Once the lease agreement is finalised, it is important to monitor lessor performance and lessee compliance with the lease terms. This includes being well aware of the termination date in advance and evaluating the lessor’s performance (against predetermined performance criteria agreed under the lease) before the final lease payment, in order to ensure that all obligations have been complied with and all the products and services that were part of the lease arrangement have been obtained.

6 Competitive neutrality

Competitive neutrality is achieved when agencies do not gain a competitive advantage or disadvantage relative to private providers from their public sector status.

The key principle is that direct procurement by the public sector must be compared with private sector providers on an equal footing, net of any regulatory or redistributive mechanisms that may exist as a matter of law or public policy.

Competitive neutrality can be addressed by incorporating into the financial analysis estimates of the financial payments that the public sector would have to make if it were subject to Commonwealth or State tax.

Some adjustments to the evaluation of leasing compared with purchasing are discussed below.

Income Taxes

The cash flow analysis for the lease evaluation should be conducted on a pre-tax basis for tax-exempt entities. Entities subject to the tax equivalent regime should evaluate the project on a post tax basis.

Goods and Service Tax (GST)

Where an input tax credit (ITC) cannot be claimed back by the agency as part of providing goods or services, the value must be included in the lease evaluation.

In the majority of cases, it is anticipated that agencies are able to claim ITC and therefore the GST would not be included in the analysis.

Insurance

The cost of the lessor's insurance will be reflected in the lease rental. The lease evaluation must be adjusted for the cost of insurance to the agency as owner as if it were insured.

Discount rates

Competitive neutrality is achieved by using a pre-tax discount rate to discount cash flows. A pre-tax discount rate ensures that financial analysis and comparisons do not become distorted by the effect of taxation. In the main, bids will reflect the individual bidder's effective tax position, which is reflected in the bidder's quote.

7 Summary

The Leasing Guidelines seek to ensure the Government receives value for money when acquiring assets by conducting a thorough evaluation of the effective cost of leasing relative to direct purchase. This requires a full assessment of the risks and benefits of the lease on a whole of life basis.

A summary of the process to be followed when considering whether to enter into a lease agreement is provided at Attachment 3.

The process includes a careful comparison of the costs and benefits of owning versus leasing and seeks to ensure a competitive process is undertaken whether the final decision is to own or lease the asset. A summary of the potential pitfalls associated with leasing is also provided at Attachment 4.

For any questions on these Guidelines and for any technical assistance, including help with the 'Asset Purchase Financing Evaluation Model', please contact SAFA Client Services on 8226 9441.

Attachment 1 — Classification of leases

Australian Accounting Standards AASB 117 Leases

This standard requires leases to be classified as either operating or finance leases at the inception of the lease.

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 provision of the lease. AASB 117, paragraph 13, outlines when a change in circumstances gives rise or does not give rise to a new classification for accounting purposes.

Paragraph 8 of AASB 117 classifies a lease upon the basis of its economic substance rather than the legal form of the contract.

- A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
- A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership.

Operating leases are essentially rental agreements whereby the lease payments shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Finance leases shall be recognised as assets and liabilities in the lessees balance sheet at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.

These are risks and rewards incidental to ownership:

- "Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions"; and
- "Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value".

If it is clear from other features of the lease that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. Eg if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards (AASB 117, paragraph 12).

Interpretation issues

Some important points to consider relate to:

- cancellation clauses;
- lease term and useful life; and
- the present value of minimum lease payments.

Cancellation clauses

When a lease is cancellable only:

(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain;

the lease is known as a non-cancellable lease.

Lease term and useful life

The Accounting Policy Framework, issued by DTF, contains guidance for estimating the useful life for many items of Property, Plant and Equipment. The lease term is the non-cancellable period for which the lessee has contracted with the lessor. The useful life of a leased property is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

The determination of useful life can be difficult in the case of long-life assets, as there may be different assessments of an asset's useful life depending upon whether the assessment relies on an accounting, economic or actuarial viewpoint.

Present value of minimum lease payments

The minimum lease payments are the payments over the lease term that the lessee can be required to make. They include rental payments over the lease term, bargain purchase options (which are likely to be paid) and any guaranteed residual. Certain items are excluded, such as executory costs, administrative costs and contingent rentals. Refer to AASB 117 for the full definition. In accordance with paragraph 20 of AASB 117, *the discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset*.

Where these rates are not explicitly stated or available, it should be calculated by the agency using relevant formulae and tables for annuities, or by the internal rate of return method. Readily available spreadsheet packages (Excel, Lotus) provide financial mathematics functions. SAFA Client Services can provide any assistance required with the calculations.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

(a) the minimum lease payments; and

(b) the unguaranteed residual value

to be equal to the sum of:

(c) the fair value of the leased asset; and

(d) any initial direct costs of the lessor.

Attachment 2 — Taxation issues

The current taxation provisions were enacted during the period when governments were the sole providers of essential public services. Over recent years, however, the private sector has increasingly become involved in all aspects of Governments procurement, ranging from the procurement of operating equipment to major infrastructure projects and the delivery of services. Taxation law has not kept pace with these developments, with the result that significant costs, complexity and delay are imposed on transactions that genuinely seek to involve the private sector in provision of property, assets and infrastructure. It is thus important for agencies to understand the reasons for the structuring of complex transactions in view of the anti-avoidance measures.

This section provides a brief outline of the main areas of tax law of interest to the tax implications of leasing arrangements with the private sector. Sections 51AD and Division 16D of the *ITAA 1936* and section 40-135 of *ITAA 1997* deal with the deductibility of depreciation, interest and other expenses for leased assets.

Section 51AD

This section operates to deny deductions for depreciation, interest, financing fees, maintenance, repairs and building allowances, while all income remains assessable for tax purposes.

Section 51AD applies to the provision of assets where the lessee is a tax-exempt entity and captures leasing transactions that have the following characteristics:

- the asset is financed predominantly by non-recourse debt. Debt is classified as non-recourse where losses in the event of default are recoverable only from the value of the underlying asset, which is sometimes guaranteed by the lessee; and

- the lease transfers the use of the asset for producing assessable income to a person other than the owner; or

- in the event that the property is not used to produce income, the ‘end-user’ controls or is able to control the use of the asset.

The purpose of Section 51AD is to prevent a Government agency (as a tax-exempt body) from accessing the benefits of the tax deductibility simply by transferring legal ownership to a tax-paying entity while retaining effective control of the asset.

The legal definition of control is influenced by both operational and financial factors, including the following:

- where the tax-exempt body operates the property through its employees or agents or is able to direct others through supervision of day-to-day operations;

- a tax-exempt body may retain a coordinating, supervisory or regulatory role without being seen to have control;

- exposure of the Government to commercial risks flowing from inefficient operation of the asset;

- Government being the principal beneficiary of rewards flowing from a well managed asset as evidenced by a ‘fixed return’ pricing mechanism that transfers the motivation for operational efficiency to Government;

- reversion of property interests or an option to acquire the asset in the future indicates that the lease merely represents an alternative means of financing;

- step-in rights other than in extreme emergencies or gross default; and
- In practice, the definition of control has often been interpreted very widely, and resolution of this issue has led to substantial delays in finalising leasing arrangements.

Division 16D

Division 16D applies to situations where the asset is financed other than by non-recourse debt but where the risks and benefits associated with ownership remain with the lessee.

Unlike Section 51AD, this provision denies only those deductions relating to capital expenditure (eg depreciation), while still allowing deductions for interest and other expenses to the extent that they apply.

Division 16D utilises qualifying tests that are similar in many respects to those applied by the now superseded AAS17 in the classification of finance and operating leases. The following pre-conditions apply:

- Section 51AD does not apply;
- there must be a *qualifying arrangement* relating to the control or use of the property; and
- the use or control must be by a tax exempt body.

The definition of a *qualifying arrangement* is as follows:

- the asset is transferred to the lessor at the end of the arrangement; or
- the period of the arrangement exceeds one year and the lessee is responsible for repairs; or
- the term of the arrangement exceeds 75% of the effective life of the equipment (50% in the case of buildings); or
- payments during the arrangement reimburse the owner for more than 90% of the cost of the asset.

There are exceptions to Division 16D that relate to the ability of the lessor to have the property classified as *plant*.

In summary, the tax laws pertaining to leasing arrangements are complex and can potentially impose prohibitive costs on leasing arrangements that would otherwise be cost-effective to Government. For complex leasing arrangements, it is advised that legal opinion be sought as to the likely treatment of the lease under the *Income Tax Assessment Acts*.

Division 16D is being reviewed and will be replaced with 250D, which is expected to remove some of the complexity and ambiguity of 16D.

Attachment 3 — Evaluation process

Step 1: Procurement decision

The process to procure assets is conducted within the framework of Treasurer's Instruction 8 *Expenditure for Goods, Services and Works*. The procurement of assets is essentially an investment decision and is undertaken within the context of an agency's asset management plan.

Step 2: Establish the total or effective cost of owning the asset

Agencies should develop a financial model of the total or effective cost of owning the asset, as described in these Guidelines. Consideration must be given to costs such as maintenance, additional operating costs, training, safety and the economic depreciation of the asset, particularly the expected residual or disposal value of the asset.

The ownership model should reflect the main risks associated with owning the asset. Sensitivity analysis should be applied to key cost factors. Relevant adjustments for competitive neutrality should also be applied. SAFA Client Services can provide any assistance required here.

Step 3: Compare ownership with leasing

A highly competitive leasing market exists for many depreciable assets such as office, medical and IT equipment and a wide range of machinery. A potential leasing transaction arises where agencies require the use of assets in circumstances where the ownership of the asset is not essential to the agency's ability to deliver its core outputs.

A preliminary estimate of the cost of ownership and leasing can be made by calculating the expected lease payments using discount rates provided by SAFA. Care must be taken to include in the leasing model, any costs identified in the ownership analysis. For example, where a maintenance lease is contemplated, the cost of maintenance to the agency as owner must be included in the analysis.

If a preliminary estimate of the likely lease costs cannot be determined with a reasonable degree of accuracy, agencies may also choose to test the market by seeking indicative quotes from lease arrangers. However, it is essential that any inquiries do not provide a competitive advantage to a particular lease arranger or group of arrangers. Respondents must also be clearly advised that the provision of an indicative quote does not in any way constitute an invitation to transact, nor will the provider be ensured of inclusion in any future tender by the agency.

Step 4: Tendering

Should the analysis indicate that leasing is a viable financing alternative, where applicable, the agency should initiate a tender, following the process required in the Prudential Management Group's tender guidelines, *Contracting Out and Competitive Tendering: Guidelines for the Private Sector*.

The tender documentation should address the issues discussed in the section titled "Documentation Issues", particularly as regards to:

- lease term;
- interim and inertia rentals;
- residual value requirements;

- cancellation options; and
- asset maintenance and service bundling.

Potential bidders must be advised to address the specific criteria provided in the tender documentation and that non-complying bids will not be considered.

Agencies must ensure that all tenders are non-binding on Government. The tender documents must provide that the agency reserves the right to reject all bids and that the cost of tendering will not be reimbursed.

Step 5: Bid evaluation

Bids should be evaluated against the risk-adjusted ownership model developed at Step 2 and the qualifying criteria provided in the tender documentation. Care must be taken to incorporate any changes to lease terms and conditions that may not have been initially incorporated in the procurement analysis to ensure that the ownership model provides an objective benchmark against which to assess bids.

Attachment 4 — Pitfalls of leasing — what to look out for

GENERAL

Leasing being more expensive than an outright purchase

The result of the 'lease versus buy' analysis may show the proposed lease rentals to be excessive.

It is important that all cash flows are included in the 'lease versus buy' analysis. It is a common mistake in completing a 'lease versus buy' analysis to overlook the estimated residual value of the asset in calculating the total cost of the purchase alternative.

Upgrades and replacements

Check the lease documentation regarding the upgrade of leased equipment. Upgrading effectively involves a termination of the existing lease, after which the lessee leases back the upgraded equipment for an extended term. A termination in this manner can allow the lessor to make windfall profits.

Incorporating other services

Lessors often attempt to include additional services (for example, maintenance of the equipment) together with the finance component of the lease under one costing and one contract. This can occur even if the additional services are not provided by the lessor, but by a third party. There are two main concerns with arrangements that contain a lease:

- lessees are not in a position to assess costs or benefits and competitiveness of the services and the finance component of the lease independently of one another; and
- lessees could lose their ability to seek recourse to the service provider if a problem arises.

Potential problems may arise if a maintenance provider fails to perform its maintenance obligations. Under most rental agreements, the lessee is obliged to continue making payments, despite any breakdown of the equipment.

In addition, where an arrangement contains a lease, the classification, recognition, measurement and disclosure requirements on AASB 117 are to be applied to the lease element only with other accounting standards determining the classification, recognition, measurement and disclosure requirements of the other elements of the arrangement.

Separating other services

In some cases, separating the payments for the lease from payments for other elements in the arrangement may require an estimation technique (Note: only in rare cases, will it be impracticable to separate the payments reliably).

For assistance in determining whether the arrangement contains a lease or separating the lease from other elements of the arrangement, please contact SAFA Client Services or the Financial Management Team in DTF.

Unclear termination values

The termination value is the amount due from the lessee where the lease terminates prior to the end of the nominal lease term. The major concern is that the lessee often has no method for verifying its calculation. Accordingly, potential exists for the lessor to exploit lessees when an early termination occurs.

Indemnities

Some lessors attempt to incorporate non-standard indemnities relating to changes in the treatment of the lease for taxation purposes. Changes to tax law are a normal risk incurred as a consequence of doing business and indemnities should not be provided, except in exceptional circumstances. In addition, Treasurer's Instruction 20 *Guarantees and Indemnities* requires a public authority to obtain the Treasurer's approval prior to giving an undertaking that binds the Government to provide a guarantee or indemnity.

OPERATING LEASES

Paying more to transfer risk

Lease payments under an operating lease normally include a premium for the acceptance of risk in the asset by the lessor and are generally more expensive than a borrowing or finance lease in net present value terms. This premium should equate to the risk being borne by the lessor.

Interim rentals

Lessors commonly nominate payment dates (generally limited to four times a year), which limit the commencement of rental terms to the specified payment dates. Where a lessee takes delivery of equipment prior to a nominated payment date, an interim rental will be required (chargeable on a pro-rata basis, calculated on the number of days from the draw down date to the payment date). Interim rentals can significantly reduce the cost-effectiveness of the lease.

Cancellation penalties

A true operating lease should enable the agency to exit the lease should the equipment become either obsolete or surplus to requirements. In cases where the equipment may depreciate more rapidly than the amortisation rate implied by the lease payment, the lessor may incorporate a commercially balanced adjustment due on cancellation.

Onerous return conditions

At the expiry of the lease, many leases require lessees to return equipment to a specific destination nominated by the lessor. It is important to ensure that this destination is convenient to the lessee, as significant disposal costs may be incurred in complying with the return clauses when the lease expires.

Automatic extension of lease term (inertia rentals)

Rental agreements often contain onerous conditions that prevent the lease from terminating on the scheduled date unless the lessee has complied with certain notice requirements. In some cases, notice may be required to be given by the lessee during a 5 to 15 day period, up to 6 months prior to the return date.

If these conditions are not adhered to, the rental agreement may be automatically renewed for an extended rental period (which may be up to 12 months from the expiration of the original term). During the extended period, the lessee has to pay inertia rentals to the lessor for the continued use of the equipment. These inertia rentals can significantly reduce the cost effectiveness of the lease.

Include Residual Value in the Lease vs Buy Analysis

The implicit lease rate quoted by the lessor needs to take into account the expected residual value of the asset. Ignoring the residual value understates the true cost of the lease to the lessee, when compared with purchasing.

FINANCE LEASES

A finance lease has similar accounting and budgeting impact to debt financing

A finance lease is analogous to a borrowing or deferred payment arrangement for outright purchase. Accordingly, the accounting standards require finance leases to be capitalised in the Statement of Financial Position of the lessee and the relevant expenditure to be funded from budget allocations.

In a finance lease there is no transfer of risk to the lessor

Under a finance lease, the risks and rewards of ownership rest with the lessee. For example, the lessee will need to manage the residual value and obsolescence risk as well as establishing appropriate disposal channels and upgrading any rollover management systems. There is an implicit cost involved in leased asset management that may be difficult to quantify.

CONTACT DETAILS

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