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Leasing

FINANCIAL PROCEDURE 19

OWNER: Head of Financial Control

CONTENTS

You should read this Financial Procedure in conjunction with the Council's -

- Code of Financial Governance

1. Introduction

1.1 This Procedure has been prepared to support the routine processes necessary to ensure proper control of the Council's finances.

1.2 The scope of this Procedure is limited to the formal write up of the lease and operational tasks while the lease is active. The issues relevant to making a decision as to whether to lease or buy are not covered here, for support in this area please contact your Senior Finance Manager in the first instance.

2. Leasing Basics

2.1 Leases generally involve a legally binding agreement principally between two parties (lessor and lessee) in regards to use of a specific asset(s), over a specific period. Lessors usually purchase the asset and therefore legally own it, if they then lease it out to another party, the other party who "use" the asset are called the lessee.

2.2 Leasing arrangements are common for IT, Office Equipment and Vehicles, though any form of asset could be leased.

2.3 Any lease that runs for less than 12 months is considered a rental/short term hire or an "Operating" lease, however any lease over 12 months in duration, could be an "Operating" lease or a "Finance" lease.

2.3 It should be noted that where the lease documentation itself outlines narrative stating the lease is "Operating" or "Finance" this is irrelevant for accounting requirements. The correct way to determine true accounting classification involves the 5 tests.

3. Operating or Finance? - 5 Tests to Apply

3.1 The following tests can be applied to existing leases for classifications or used to ensure future leases entered into are either "Operating" or "Finance";

- Does the lease <u>transfer ownership</u> of the asset to the lessee at/by the end of the term?
- Does the lease give the lessee the <u>option to purchase</u> the asset at less than Fair value?
- At the inception of the lease, is it reasonable to assume that the lessee & lessor either;
    - (a) expected the lease terms to be for the <u>major part of the economic life</u> of the asset (CBC assumes over 75%), or
    - (b) that the <u>residual value</u> on expiry of the lease term would be negligible?
- Lease <u>payments represent a major part</u> of value of asset (CBC assumes over 75%)?
- Is the asset of such as <u>specialist nature</u>, that only the lessee can use them without modifications. This is extremely rare and will in most cases be a "No".

3.2 If you answer "Yes" to any of the above questions (not necessarily all), your lease is a Finance Lease. If all answers are "No" you have an operating lease.

3.3 Where a lease contains use of land as well as a building, the land proportion is considered to be an "Operating" lease due to Land's infinite life, whereas the buildings classification could be either "Operating" or "Finance" depending on the leases terms compared to the 5 tests in paragraph 3.2.

3.4 As Schools are not allowed to enter into “Finance” leases legally, a process note is provided on Appendix A to outline the issues to be considered.

4. General Economic Life of Assets

4.1 The third test asks if *“the lease terms to be for the major part of the economic life of the asset”* and states the Council’s accounting policy is *“major part”* to mean over 75% of its useful life. The following table provides a basic guide to types of assets, their general lives and therefore maximum lease length terms if the lease is to be considered “Operating”:

Asset classification:	**Asset Life**	**Terms to 75% of asset life**	**Likelihood**
Plant and equipment	10 years	Less than 8 year term	Very likely
Operational buildings	50 years	Less than 38 year term	Very likely
Vehicles	10 years	Less than 8 year term	Very likely
Intangible assets	10 years	Less than 8 year term	Possible
Infrastructure	30 years	Less than 23 year term	Possible
Council houses	60 years	Less than 45 year term	Very unlikely

4.2 The asset lives are provides as guides only, should a more reliable life term be known, that should be used in the 5 test calculations.

4.3 Ensure you do not lease assets (as a lessee) for longer than the asset life, it is acceptable to lease an asset for less than the useful life but not more.

5. Basic Accounting for Leases

5.1 The issue of whether the lease is “Operating” or “Finance” is key for the accounting of both parties within the agreement.

5.2 An “Operating” leases is relatively straight forward with the amounts transferred to and from each party running through the party’s Income and Expenditure accounts only with no balance sheet implications. The ease of “Operating” lease accounting means it is often seen as beneficial (where there is discretion to do so) to classify leases as “Operating”, rather than “Finance”.

5.3 A “Finance” lease is more and will have considerable balance sheet implications. The first question is “who holds the asset in their balance sheet”? Given the principles of a “Finance” lease means the risks and rewards are transferred to the lessee it should be on the lessee’s balance sheet, not the lessor’s;

Lessor- Finance lease	Lessee- Finance lease
Off balance sheet	On balance sheet

5.4 But whilst the lessor “loses” the balance sheet asset in terms of fixed asset value, this is replaced by a legal commitment by the lessee to pay the lessor for the “use” of the asset being leased. This means a debtor balance is set up on the lessor’s balance sheet for the value of the lease payments over the life of the lease.

5.5 Likewise, whilst the lessee “gains” the balance sheet asset in terms of fixed asset value, this is off-set by a legal commitment by the lessee to pay the lessor for the “use” of the asset being leased. This means a creditor balance is set up on the lessee’s balance sheet for the value of the lease payments over the life of the lease.

5.6 Whilst the rules and tests are aimed at consistency to ensure only one asset value is on balance sheet per lease across the two parties, due to differing interpretation of the rules and therefore differing accounting policies it is still possible for different classifications of the same lease into “Operating” or “Finance” to occur or become evident. However, this is expected to be rare.

6. Lease Terms

6.1 This section asks the questions future lessee’s / lessor’s must ask about the lease’s clauses, before the lease is signed. Lease negotiations are a two-way street, so do not feel either you have to accept terms set by the other party or be afraid to set your own terms. Negotiating terms is also critical if you need the lease to have a specific classification, usually “Operating” not “Finance”.

6.2 Each lease is negotiated on its own merits, if you are not happy with any terms of a draft lease ask them to be changed.

6.3 Paragraph 3.1 has already outlined the importance of termination clause where at the end of the lease the assets are passed over to the lessee legally. This is less likely to be an issue if the lease is for the full period of the assets life, as it will probably have little fair value at that point. However if the lease was for only a proportion of an assets life, there will be residual value left at expiry and therefore transferring that would be a loss to the lessor and a gain to the lessee. Whilst there are good reasons for transfer of assets at the end of the lease term (for example cost implications of removing the asset from the lessee’s site) it is expected that most leases the Council enters into will not transfer the assets at the end of the lease either for free or at a level significantly below fair value.

6.4 Payment terms should usually be specified and depending on the position in the transaction will differ greatly in ideal terms. For example as a lessor it would be ideal to receive the payment in advance or at the start of the year, whilst as a lessee it would be ideal to pay in arrears or at the end of the year. Whilst the amount will be set and thus do not change, the cash flow implications are that it costs the Council more to pay in advance for something than in arrears (time value of money and lost investment opportunity). This will be a negotiation but we should start with the ideal for ourselves and accept a middle ground if negotiated down, for example 12 monthly payments by 15th of each month, would be a suitable middle ground.

6.5 Different classes of assets should not be mixed on one lead schedule, each type of asset should have a separate lease agreement. Mixing assets causes considerable confusion in accounting for assets. The most likely issue is land and building splits- in these cases a work around could be made where the lease sets proportions for each element, for example 30% land 70% building, which can then be used on the total lease costs.

6.6 Within any lease ensure the termination clauses are clear, for example who is responsible for paying for the return of the assets, where are they to be returned to, what service paperwork must have been maintained and be passed over?

6.7 As with all legal agreements penalties for failure to adhere to lease terms will be stated. Ensure the implications of terms are understood particularly if penalties could be levied, for example simple late payment penalties or if the lease says the Council will return the vehicles on the last day of the lease agreement or face a 1% annual surcharge for every day beyond this, it is imperative that the vehicles are returned on the day set. Penalties can be severe and are a revenue expense, so please ensure all key dates and terms are adhered to, to minimise cost.

6.8 Extension terms, even with the best termination planning, can become necessary. As the Council is tasked to ensure service delivery without break, it may become evident that an extension term becomes needed. If you feel that this may occur due to the assets nature or service area being business critical it is suggested that acceptable extension terms be set in the lease. Once the lease is signed any extension would need to be an amendment or new lease agreement and the closer to the expiry date the less bargaining strength the lessee has.

6.9 Please beware of unusual or restrictive covenants in the lease, if you don’t like the clause ask for it to be removed.

7. Involve your Legal / Finance Teams

7.1 Whenever leasing is being considered or is being actioned, ensure your Legal and Finance teams are involved from the start to ensure accounting policies are adhered to and the lease is as appropriate as possible.

7.2 If your lease is a “Finance” lease, Finance will need the following as a minimum to establish the accounting treatment at year ends;

- Asset value
- Length of lease- start / finish plus break clause dates
- Initial direct costs (usually lessor only)
- Payment terms
- Residual value at lease expiry date

Appendix A

Schools Leasing- Process Note

Owing to the way Schools are funded, there is a legal requirement in relation to leasing assets that must be adhered to. This simple process note is aimed to guide you through the process before leases are signed and therefore should be considered during the procurement process.

What types of leases are there?

There are primarily two types of leases in accounting terms: Finance and Operating.
Leases in this note are legal agreements over 12 months in length. Anything under 12 months in length is exempt from this exercise.

Am I the lessor or lessee of an asset?

Lessors usually purchase the asset and therefore legally own it. If they then lease it out to another party, the other party who "use" the asset are called the lessee.
Within schools, it is much more likely that the school will be lessee, than lessor. This process note therefore focuses on schools as lessee.

How do I make sure I do not enter a Finance lease if I am not allowed to?

Leases will often contain the phrase "operating" or "finance" lease, these are legal definitions and as such may not meet the accounting definitions set by statute. For example, given a set of terms for a lease of gym equipment, the lease may be headed a Finance lease but after application of the test to determine the accounting classification it may be evident that the lease is an operating lease. Therefore the leases title itself should never be used to determine the lease classification, application of the following 5 tests are the only way to determine correct accounting classification.

1) Does the lease transfer ownership of the asset to the lessee at/by the end of the term?
2) Does the lease give the lessee the option to purchase the asset at less than Fair value?
3) At the inception of the lease, is it reasonable to assume that the lessee & lessor either
   (a) expected the lease terms to be for the major part of the economic life of the asset (CBC assumes over 75%), or
   (b) that the residual value on expiry of the lease term would be negligible?
4) Do total lease payments represent a major part of value of asset (CBC assumes over 75%)?
5) Is the asset of such as specialist nature, that only the lessee can use them without modifications. This is extremely rare and will in most cases be a "No".

If you answer "Yes" to any of the above question (not necessarily all), your lease is a Finance Lease and therefore should not be entered into as set. Negotiations will then need to be made on the terms that have made this a Finance lease with a view to making it an Operating lease.

What terms should I be looking for?

The asset transfer at the end of the lease can simply be negotiated away, if the lessor insists on transfer to the school and the end of the lease term, schools cannot sign the lease.
The asset purchase clause at the end of the lease can simply be negotiated away, if the lessor insists on inclusion of this clause, schools cannot sign the lease.
The lease length to asset life ratio usually goes hand in hand with lease payments proportion to asset value. Although both will still have to be calculated, as a guide the general life of assets are outlined below which then give a operating lease guide to maximum term length, if the lessor insists on term length over these maximums, schools cannot sign the lease.

Asset classification:	Asset Life	Terms to 75% of asset life	Likelihood for schools
Plant and equipment: • Computers • Class Equip • Other IT Equip	 5 years 5 years 5 years	 Less than 4 year term Less than 4 year term Less than 4 year term	 Very likely Very likely Very likely
Operational buildings	50 years	Less than 38 year term	Possible
Vehicles	10 years	Less than 8 year term	Possible
Intangible assets	10 years	Less than 8 year term	Possible
Infrastructure	30 years	Less than 23 year term	Unlikely
Council houses	60 years	Less than 45 year term	Unlikely