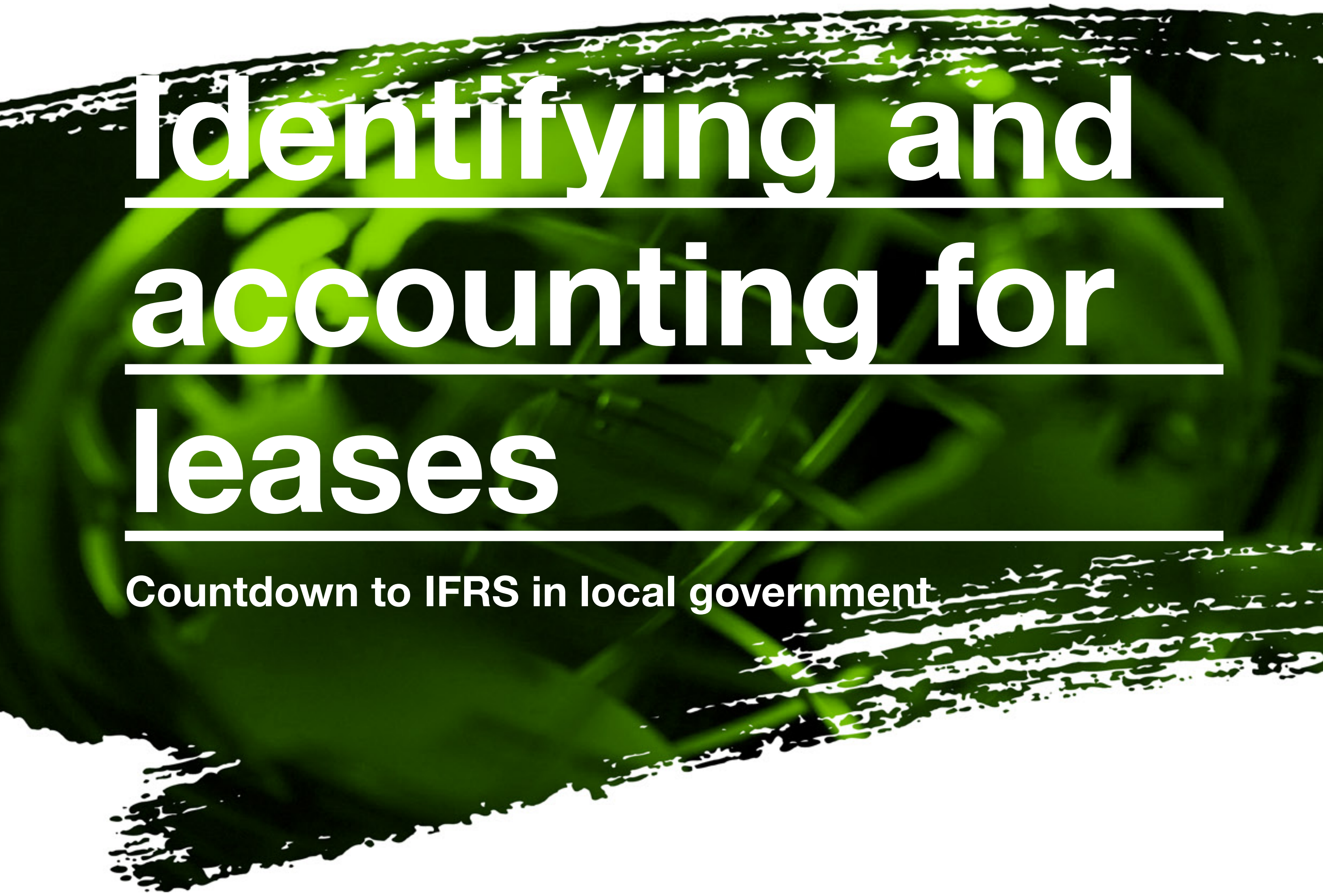


Identifying and accounting for leases

Countdown to IFRS in local government

In *Countdown to IFRS*, published in February 2010, we said that we would be issuing a series of briefing papers covering the technical issues local authorities need to address now if they are to achieve a smooth transition to IFRS. This is the first in that series and looks at the issues arising from the introduction of *International Accounting Standard (IAS) 17: Leases.*

In our November 2009 survey, auditors assessed only 14 per cent of authorities as on track to deliver IFRS financial statements compliant with IAS 17 for 2010/11. Twenty-seven per cent were assessed as having major issues and 59 per cent with minor issues.

Authorities need to have a detailed plan to ensure they identify all arrangements falling under IAS 17 and that they account for such arrangements correctly. This briefing paper sets out some of the key issues and practical examples that authorities should consider as part of their work on the review of lease arrangements.

audit commission

Potential arrangements

Authorities are involved in a wide range of arrangements that involve the use of an asset or assets. When considering the appropriate accounting for that arrangement under IFRS, it is important to understand the nature of the arrangement at an early stage.

Some of these arrangements will need to be accounted for as service concessions in accordance with IFRIC 12; others will need to be accounted for as leases under IAS 17. The first step is to identify the range of different arrangements the authority is involved in. Authorities then need to consider which accounting route to follow in each case. This section explains the process that needs to be followed.

In *Countdown to IFRS*, we noted that *IFRIC 12: Service Concessions* can cover more than PFI schemes. Alongside IFRIC 12, *IFRIC 4: Determining Whether an Arrangement Contains a Lease* looks at those arrangements that, while not taking the legal form of a lease, are in substance leases for accounting purposes. Taken together, IFRIC 12 and IFRIC 4 provide a clear framework for considering how to recognise arrangements including the use of an asset for accounting purposes.

IFRIC 12 contains three key tests that indicate whether an arrangement should be recognised as a service concession and the related assets, therefore, recognised on the balance sheet:

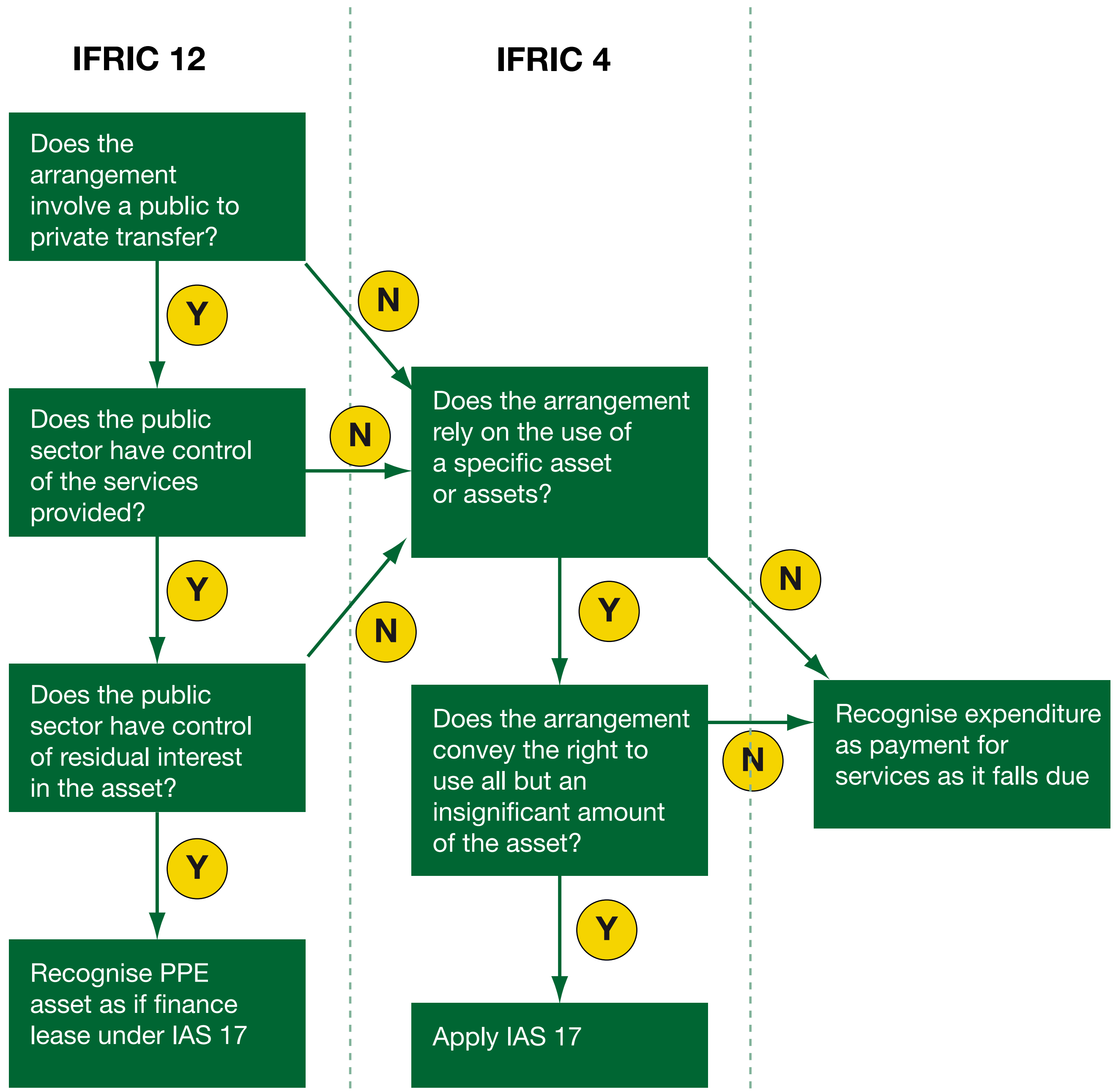
- there is a public to private transfer – that is, the services are provided by a private sector partner;
- the public sector has control of the services to be provided; and
- the public sector controls the residual interest in the property.

If any of these tests are not met, the arrangement is not recognised as a service concession. At that point, it is necessary to consider whether the arrangement contains a lease in accordance with IFRIC 4. Again, there are two key tests that indicate whether the arrangement contains a lease:

- the arrangement relies on the use of a specific asset or assets; and
- the arrangement conveys the right to use all but an insignificant amount of the asset.

The following diagram summarises these thought processes.

Figure 1: **Decision Tree: Lease arrangements identification process**



Source: Audit Commission

An authority may be involved in two similar arrangements in the provision of a service; the first involving a private sector service provider and the second another public sector body. The first arrangement should be considered initially under IFRIC 12 as the arrangement is between a private sector provider and a public sector body. Applying the flowchart in Figure 1, if the authority meets the three tests, the asset would be included on the authority's balance sheet.

However, in the second situation, where the service is provided by another public sector body rather than a private sector provider, IFRIC 12 does not apply. The authority will need to consider the arrangement under IFRIC 4. Applying the flowchart in Figure 1, if the two conditions are met, the authority will need to apply IAS 17. In accordance with IAS 17, it is possible that the arrangement may be accounted for as an operating lease and, therefore, the asset will not be recognised on the authority's balance sheet.

An arrangement that meets the requirements of IFRIC 4 can take various forms

An arrangement that meets the requirements of IFRIC 4 can take various forms, including arrangements between public sector bodies as discussed above and licences to operate. The following provides an example of such an arrangement.

> An authority has outsourced its refuse collection arrangements to a private sector provider under a licence to operate. Under the arrangement, the operator purchases a new fleet of refuse vehicles, paints them in the authority's colours and uses them exclusively for the authority's refuse collection contract.
>
> Under the arrangement, the authority has the right to use the refuse vehicles. Also, as they are used exclusively on the authority's refuse collection contract, the arrangement conveys the right to use all but an insignificant amount of the asset. As a result, the authority would need to consider the arrangement under the terms of IAS 17 and may have to recognise the assets on the balance sheet as a finance lease.

Reviewing arrangements

Many authorities will have large numbers of leases of varying sizes and complexity and may also identify arrangements containing leases as defined by IFRIC 4. They will need to consider how they review those leases to ensure that their restated accounts are IFRS-compliant. Authorities need to put in place a timetable and approach for identifying and reviewing all leases. Experience from the private sector[i] and the NHS[ii] has shown that this is a time-consuming and resource intensive exercise. There is a risk that, without a proper plan and set timescales, all lease arrangements may not be identified and therefore the financial statements will not be complete.

i Deloitte, *IFRS Insights – IFRS Conversion: Some Important Lessons Learned*, www.iasplus.com/usa/ifrsinsights/0903ifrsinsights.pdf

ii *IFRS Briefing Paper 3 for Health: Managing the Transition to International Financial Reporting standards*, www.audit-commission.gov.uk/ifrs

The starting point to this must be a clear understanding of what assets are being used under what arrangements. Therefore, as a priority, authorities need to identify any arrangement that involves the use of an asset. As we emphasised in *Countdown to IFRS* this is not something that can be done by the finance department alone. Operational staff across the organisation, including in schools, will have a better understanding of what assets they are using and should be able to provide documentary evidence to support any review of the nature of the arrangement.

Authorities should take a risk-based approach

The resulting number of arrangements that need consideration under IAS 17 could be large. The key to managing a review of that size will be to take a risk-based approach. Possible approaches include:

- reviewing standard contracts or lease terms (for example, authorities may be able to group leases for vehicles or photocopiers where these have been procured through a central leasing contract);
- reviewing a sample of leases contracts for a particular class of leases where contracts are standard and extrapolate the results across the whole class;
- identifying material leases and focusing on the accounting treatment for these;
- tailoring discussions with departments focusing on the assets they use; and
- assigning a 'lead' for each type of asset (for example, buildings or vehicles).

When undertaking assessments, authorities will need to ensure that they have available all of the information necessary for forming a view on accounting treatment. Details of the lease term, including any break clauses and review periods, and lease payments should be available from the lease contract, so it is important that authorities have traced all the relevant lease documentation. Estimates of the fair value of the asset may also be available from the lease contract. However, if not available, it may be necessary to instruct valuers to provide a valuation. The lead-in time for getting valuations, particularly if there are a significant number of assets to value, can be lengthy. Therefore, it is important that this requirement is identified early to ensure all necessary work is undertaken to enable the restatement to take place.

Authorities can take steps to help identify any future lease arrangements by putting into place an effective system and processes for service and legal departments to follow. For example, a generic form to be completed by all departments as part of the procurement process that sets out the arrangement and is sent to the finance department.

Applying IAS 17

In many respects, IAS 17 is similar to SSAP 21, the UK standard under which leases are currently recognised. The definition of finance and operating leases is the same and the consideration of the classification of a lease focuses on the transfer of risks and rewards.

Accounting treatment will depend on the consideration of a number of qualitative tests

However, there are some significant differences that may result in leases being reclassified from finance to operating leases on restatement to IFRS.

Most significantly, the '90 per cent test' in SSAP 21 does not exist in IAS 17. While there is an equivalent test of assessing whether the net present value of the minimum lease payments amounts to at least substantially all of the fair value of the asset, no quantitative value is applied to this. Rather, under IAS 17, this is one of several qualitative tests that, individually or in combination, would normally lead to a lease being classified as a finance lease. Paragraph 10 of IAS 17 states:

> Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
>
> - 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 fair value at the date the option becomes exercisable and that, at the inception of the lease, it is reasonably certain that the option will be exercised;
> - 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; and
> - the lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Authorities will need to consider the impact of these situations, individually or in combination, on all of their material leases. This may result in more leases being classified as finance leases.

IAS 17 also requires the separate consideration of land and buildings within a lease arrangement. Unless ownership of the land transfers to the lessee at the end of the lease term, the standard assumes the lease of the land would be recognised as an operating lease. The building is then considered under the standard and could be recognised as a finance lease on the balance sheet. By comparison, SSAP 21 has an underlying assumption that leases of land and buildings would be considered together and recognised as operating leases.

In keeping with the other IFRSs and IASs, IAS 17 also requires more disclosure than UK standards. Those additional disclosures, which are specified in the standard, may require gathering more information than is currently available. Authorities, therefore, need to identify the information required for disclosure and ensure that this is available.

Authorities could consider using their internal audit departments to provide assurance that they have correctly identified and applied the accounting standards. Internal audit can sample test leases that will be included in the financial statements and also those that are not.

Further information

Please visit www.audit-commission.gov.uk/IFRS for more information about IFRS and implementation work.

Stock code: LEB3614

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For further information on the work of the Commission please contact:
Audit Commission, 1st Floor, Millbank Tower, Millbank, London SW1P 4HQ
Telephone: 0844 798 3131 Fax: 0844 798 2945 Textphone (minicom): 0844 798 2946
www.audit-commission.gov.uk