

4.2 Leases and Lease Type Arrangements

A - Reclassification of Leases

The requirements of the Code in respect of lease classification are different to those of the SORP. Authorities will therefore need to review their lease arrangements to determine whether or not leases need to be reclassified. Leases classified as operating leases under the SORP may be classified as finance leases under the Code, and leases classified as finance leases under the SORP may be classified as operating leases under the Code. Such reclassifications may occur where the authority is acting as a lessee and as a lessor.

There are two main reasons why leases may need to be reclassified under the Code.

Firstly, where a lease is a lease of property, the land and buildings elements are considered separately for the purpose of lease classification. Under the SORP, both elements would have been considered together. The likely effect of this requirement is that, for some property leases classified as finance leases under the SORP, the land element will be reclassified as an operating lease; and for some property leases classified as operating leases under the SORP, the buildings element will be reclassified as a finance lease. In considering the lease classification of property leases, regard should be paid to the following paragraph of the Code:

- 4.2.2.9 Leases of land and buildings are classified as finance or operating leases in the same way as leases of other assets. However the land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification. When the land has an indefinite economic life, the land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term (i.e. in determining whether the land element is an operating or finance lease, an important consideration is that land normally has an indefinite life; a lease of land may be a finance lease where the title does not pass to the lessee by the end of the lease term if consideration of all the factors leads to this conclusion). A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.*

The second reason that may lead to a lease being reclassified under the Code is that the SORP definition of a finance lease included the following statement:

A finance lease is one that transfers substantially all of the risks and rewards of ownership of a fixed asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments including any initial payment amounts to substantially all (normally 90% or more) of the fair value of the leased asset. The present value should be calculated by using the interest rate implicit in the lease. However, where the present value of the minimum lease payments does not amount to 90% or more of the fair value of the leased asset, it should not be automatically assumed that the lease is not a finance lease. FRS 5 requires that the substance of the transaction be reflected and therefore the lease may still need to be classified as a finance lease.

Notwithstanding the fact that the lease meets the definition above, the presumption that an asset should be classified as a finance lease may in exceptional circumstances be rebutted if it can be clearly demonstrated that

the lease in question does not transfer substantially all the risks and rewards of ownership (other than legal title) to the lessee.

The equivalent test under the Code (following IAS 17 and IPSAS 13) does not include any guidance regarding the meaning of 'substantially all of the fair value'; the '90% test' in the SORP no longer applies. As a result, a greater degree of professional judgement will be required when assessing whether a lease is a finance lease or an operating lease. It is possible that, where authorities had relied solely on the 90% test in the past, leases may need to be reclassified.

Paragraph 4.2.2.7 of the Code includes five examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease. These are:

- 1) the lease transfers ownership of the asset to the lessee by the end of the lease term*
- 2) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value so as to make it reasonably certain the option will be exercised*
- 3) the lease term is for the major part of the economic life of the asset*
- 4) the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset, and*
- 5) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.*

It should be noted that the definition of 'minimum lease payments' excludes contingent rents. Contingent rents are treated as expenditure or income (in service revenue accounts) in the year in which they occur.

Paragraph 11 of IAS 17 includes some further examples of situations that could (individually or in combination) lead to a lease being classified as a finance lease. These are:

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;*
- (b) 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 equalling most of the sales proceeds at the end of the lease); and*
- (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.*

As both the Code and IAS 17 note, the examples above 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.

The test as to whether a lease is a finance or operating lease is whether it transfers substantially all the risks and rewards incidental to ownership. The examples above may provide an indication that this has occurred, but no single indicator is paramount or conclusive on its own. A decision has to be reached on the basis of all factors affecting a lease.

There is no specific guidance regarding the meaning of 'substantially all'; this has to be judged in the context of the lease. This will also avoid leases being structured to

'pass' a particular test and therefore be classified as an operating lease even though other indicators may suggest the lease is a finance lease.

Following the change to IAS 17 included in the Improvements to IFRS issued by the IASB in 2009 (and adopted by the EU in March 2010), classification of a lease of land is on the same basis as for all other assets, although it should be noted that in determining whether the land element is an operating or finance lease, an important consideration is that land normally has an indefinite life. This Code has adopted this approach.

This guidance assumes that, in Scotland and Northern Ireland, charges for the principal element of finance lease repayments have been made outside of the Loans Fund. Where this is not the case, authorities will need to give further consideration as to how the Loans Fund charges should be restated; the approach to restating Minimum Revenue Provision in England and Wales may be an appropriate starting point for these deliberations.

Step 1 - Restate Opening IFRS Balance Sheet as at 1 April 2009

- 10.1.2.40 The Code (following IFRS 1) requires local authorities to classify and account for leases in their opening IFRS balance sheet (1 April 2009) in accordance with section 4.2 of the Code (see also IAS 17 and IPSAS 13). Authorities will therefore need to separate leases of land and buildings into land and buildings elements, and classify and account for those elements separately. Authorities may also need to recognise a lease that was previously recognised as an operating lease as a finance lease, or recognise a lease that was previously recognised as a finance lease as an operating lease. These requirements are applied retrospectively, and apply when accounting both as a lessee and as a lessor.

Where authorities have a significant number of leases, it may be appropriate to prioritise leases to ensure that effort is directed to those leases that are more likely to be reclassified or which are material.

Separation of Land and Buildings Leases

- 10.1.2.41 To separate leases of land and buildings into the separate land and buildings elements, authorities will need to review the lease contracts, and separate each lease on the basis of the position at the inception of the lease. Lease payments are allocated to the land and buildings elements in proportion to their relative fair values. The fair values of the land and buildings elements will therefore need to be established as at the inception of the lease.

Valuers will need to be involved in estimating the fair values of the land and buildings elements at the inception of the lease. Authorities should note that when separating the lease into its land and buildings element, the relative fair values to be used are the relative fair values of the leasehold interests. The requirement to separately account for leases of land and buildings applies when acting as both a lessee and as a lessor. The following paragraphs cover the accounting treatment required on transition to IFRS where leases are reclassified.

Lease Reclassification – Accounting as a Lessee

Operating Lease Reclassified as a Finance Lease

- 10.1.2.42 Where an operating lease is reclassified as a finance lease, an asset and a liability shall be recognised. Authorities will need to establish the fair value of the asset. Where this is not known, the fair value of the asset can be estimated by taking the present value of the minimum lease payments (discounted at the rate implicit in the lease). If the rate implicit in the lease cannot be established, the authority's incremental borrowing rate at the date of reclassification shall be used.

Where information regarding the fair value of the asset at the inception of the lease is not available, authorities will need to estimate the fair value. One method would be to take the present value of the minimum lease payments, discounted at the interest rate of the lease. Some lease contracts may specify the interest rate, in which case this rate should be used. Where the interest rate is not specified, an authority will need to estimate the implicit rate in the lease. In estimating the implicit rate of interest, the residual value of the asset will be an important factor. The SORP Guidance Notes 2009/10 include a worked example of how to calculate the implicit rate of interest; the example appears in Module 7, starting at paragraph C40. The example is provided in the context of accounting for PFI schemes, but also applies to leases. An authority's incremental borrowing rate should be used where the implicit rate in the lease cannot be established; this might be the case where information about neither the interest rate nor the fair value of the asset is available. IAS 17 defines the incremental borrowing rate as:

... the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

As most authorities would normally borrow from the Public Works Loan Board, the PWLB web site may be helpful in establishing an authority's incremental borrowing rate.

Where an authority has information about both the fair value of the asset and the interest rate implicit in the lease, the asset and liability should be recognised initially at the present value of the minimum lease payments where this is lower than the fair value of the asset.

Authorities will need to recognise the asset and the liability at the inception of the lease in the opening IFRS balance sheet. The entries required are as follows:

*Dr Property, Plant and Equipment
Cr Financial Liability*

With the fair value of the asset or, if lower, the present value of the minimum lease payments

- 10.1.2.43 Payments made between the inception of the lease and 31 March 2009 shall be apportioned between the finance charge and the repayment of the liability. These amounts would previously have been charged to the General Fund.

The element of the payments that relates to the repayment of the liability (calculated using the actuarial method) will need to be taken to the balance sheet to reduce the liability. The entries required are as follows:

*Dr Financial Liability
Cr General Fund*

With the element of the payment that relates to the repayment of the liability

- 10.1.2.44 Depreciation on the assets acquired under the lease will need to be charged from the commencement of the lease until 31 March 2009. This should be in accordance with an authority's depreciation policies. Assets will also need to be revalued in accordance with the authority's revaluation policies.

Once recognised as property, plant and equipment, the asset will need to be depreciated in accordance with the authority's accounting policies. As depreciation is not a proper charge to the General Fund under legislation, it would then be

reversed out to the Capital Adjustment Account. In restating the opening IFRS balance sheet, the entries required are as follows:

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With the depreciation chargeable from the commencement of the lease until 31 March 2009

The asset will also need to be revalued in accordance with the authority's accounting policies. Where the value of the asset increases, the increase will be credited to the Revaluation Reserve. Where the value of the asset decreases, the decrease would, under the Code, be charged to the General Fund and then transferred to the Capital Adjustment Account. The entries required are therefore as follows:

*Dr Property, Plant and Equipment
Cr Revaluation Reserve*

With any revaluation increase

OR

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With any revaluation decrease

- 10.1.2.45 The General Fund shall be charged with the Minimum Revenue Provision (England and Wales) or repayment of the liability (Scotland and Northern Ireland) as required by regulation or statutory guidance.

In England and Wales, the statutory guidance recommends that the Minimum Revenue Provision (MRP) on transition to IFRS (i.e. in 2010/11) is increased by the element of the payments allocated to reduce the liability.

The general principle under both the Code and IAS 8 is that changes of accounting policy are accounted for retrospectively. This is to ensure that financial statements are presented on a comparable basis. It should be noted that this applies equally to transactions arising out of legislation (for example, any tax effects of a change in accounting policy are restated retrospectively) and hence applies to statutory transactions such as MRP. The MRP to be transferred between the General Fund and the Capital Adjustment Account in respect of restated leases arises out of a change in an accounting policy, and the Local Authority Accounting Panel therefore recommends that the portion of the increase in MRP arising on transition to IFRS that relates to transactions up to 31 March 2009 is presented as a charge to the General Fund in the opening IFRS Balance Sheet.

On this basis, presenting the figures as if the regulations and guidance apply is appropriate, and will increase the usefulness of the comparative figures. The notes to the accounts will need to include a statement that the comparative figures are based on the regulations and guidance even though those regulations and guidance only apply from 1 April 2010, and disclose the amount of MRP charged in the year (showing both the amount arising on transition to IFRS and the amount arising in the year).

Where authorities follow the recommendation above, the following entries will be required:

*Dr General Fund
Cr Capital Adjustment Account*

With MRP in relation to transactions up to 31 March 2009

Where authorities do not follow the recommendation above, entries will be required in 2010/11 (see the guidance under paragraph 10.1.2.52)

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability up to 31 March 2009 should be charged to the General Fund (District Fund in Northern Ireland) in the opening IFRS Balance Sheet. The entries required are as follows:

*Dr General Fund / District Fund
Cr Capital Adjustment Account*

With the element of the payment that relates to the repayment of the liability

A worked example is given as scenario A1 in the spreadsheet.

Finance Lease Reclassified as an Operating Lease

- 10.1.2.46 Where a finance lease is reclassified as an operating lease, the asset and liability will need to be derecognised. Any Minimum Revenue Provision (England and Wales) or repayment of the liability (Scotland and Northern Ireland) shall be adjusted in accordance with regulations or statutory guidance if required.

Where a lease that was classified as a finance lease under the SORP is reclassified as an operating lease under the Code, authorities will need to derecognise the asset and liability, and reverse the finance lease interest charged to the General Fund. Authorities will then need to adjust the General Fund to reflect the operating lease charges.

The entries required are as follows:

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With the carrying amount of the leased asset

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With any balance on the Revaluation Reserve in respect of the leased asset

*Dr Financial Liability
Cr Capital Adjustment Account*

With the outstanding lease liability

*Dr General Fund
Cr Capital Adjustment Account*

With the difference between the finance lease interest charged up to 31 March 2009 and the operating lease charges up to 31 March 2009.

In England and Wales, legislation requires authorities to make a prudent MRP charge. It is recommended that the charge in 2010/11 is reduced by the amount of MRP previously charged on leases that are reclassified as operating leases; this will

be prudent because the amount previously charged as MRP will be recovered through the operating lease charges to the General Fund. The Local Authority Accounting Panel recommends that the portion of the reduction in MRP that relates to transactions up to 31 March 2009 is credited to the General Fund in the opening IFRS Balance Sheet, for the reasons set out in the guidance above (under paragraph 10.1.2.45).

Where authorities follow the recommendation above, the following entries will be required:

*Dr Capital Adjustment Account
Cr General Fund*

With the amount charged to the Fund in respect of MRP up to 31 March 2009

Authorities should note that, under section 7 of the Local Government Act 2003, leases would have been classified as credit arrangements at the date they were entered into. At the time of writing this guidance, it is unclear whether a reclassification of the lease as an operating lease is sufficient to change this classification as a credit arrangement. If further investigation confirms that the classification as a credit arrangement will remain, it is anticipated that the Department of Communities and Local Government and the Welsh Assembly Government will consider introducing new regulations during 2010/11 to remedy the situation.

It should be noted that classification as a credit arrangement makes the leases subject to the MRP arrangements. However, the calculation of the Capital Financing Requirement is determined by the Prudential Code, which follows the accounting treatment of the leases. Although it is possible the leases would still be classified as credit arrangements under the Act, the amount included in the Capital Financing Requirement in respect of the leases will be a credit amount in respect of the MRP previously charged. As the balance is a credit balance, and the requirement of the regulations require a prudent MRP to be made, a reduction in the overall MRP charged to effect a reversal of the MRP previously charged in respect of these leases would appear to be a prudent approach.

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the General Fund (District Fund in Northern Ireland) should be credited with the amount previously charged up to 31 March 2009 in the opening IFRS Balance Sheet. The entries required are as follows:

*Dr Capital Adjustment Account
Cr General Fund (District Fund)*

With the amount charged to the Fund in respect of finance lease principal repayments up to 31 March 2009

A worked example is given as scenario A2 in the spreadsheet.

Lease Reclassification – Accounting as a Lessor

Operating Lease Reclassified as a Finance Lease

- 10.1.2.47 Where an operating lease is reclassified as a finance lease, the asset shall be derecognised and a long-term debtor recognised.
- 10.1.2.48 For each lease, authorities will need to separate the lease income into a finance income element and a repayment of principal element. The repayment of principal element of each payment shall be applied to reduce the balance on the long-term

debtor, and is classed as a capital receipt; a transfer from the General Fund to the Capital Receipts Reserve (Capital Fund in Scotland) is required unless regulations or statutory guidance permit otherwise.

Where a lease that was classified as an operating lease under the SORP is reclassified as a finance lease under the Code, authorities will need to derecognise the asset they would have been carrying in their balance sheet, and recognise a long-term debtor reflecting the lessee's obligation to make lease payments to the authority. Under the SORP, lease income would have been credited to the General Fund; under the Code this income will need to be allocated to an interest element (credited to the General Fund) and an element that reduces the long term debtor. The entries required are as follows:

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With the carrying amount of the leased asset

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With any balance on the Revaluation Reserve in respect of the leased asset

*Dr Long-Term Debtor
Cr Capital Receipts Deferred*

With the initial value of the long-term debtor (the amount recognised as the disposal proceeds)

*Dr General Fund
Cr Long-Term Debtor*

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

In England and Wales, regulations¹ require authorities not to classify the repayment of the principal element as a capital receipt for leases entered into on or before 31 March 2010, but to retain it in the General Fund as income. The entries required are as follows:

*Dr Capital Receipts Deferred
Cr General Fund*

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund. The entries required will be as follows:

¹ The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2010 (SI 2010 No. 454) and The Local Authorities (Capital Finance and Accounting) (Amendment) (Wales) Regulations 2010 (SI 2010 No. 685 (W.67))

*Dr Capital Receipts Deferred
Cr Capital Fund*

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

A worked example is given as scenario A3 in the spreadsheet.

Finance Lease Reclassified as an Operating Lease

- 10.1.2.49 Where a finance lease is reclassified as an operating lease, the long-term debtor shall be derecognised and the asset that would have been derecognised at the commencement of the finance lease shall be reinstated. The balance on the fixed asset account shall be adjusted for the depreciation chargeable between the time the asset was originally derecognised and the time it is reinstated. The asset may also need to be revalued.

Where a lease that was recognised as a finance lease under the SORP is reclassified as an operating lease under the Code, authorities will need to reinstate the asset that was written out of the balance sheet as a disposal by way of a finance lease. The asset value will need to be adjusted to reflect any depreciation due from the point of disposal until 31 March 2009. Depending on when the asset was last revalued, it might also be necessary to revalue the asset as at 31 March 2009.

When the finance lease was recognised under the SORP, a long-term debtor would have been recognised. This will need to be derecognised.

The entries required to reinstate the asset and derecognise the long-term debtor are as follows:

*Dr Property, Plant and Equipment
Cr Capital Adjustment Account*

With the value of the asset at the point of disposal under the SORP

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the value of any balance on the reserve in relation to the asset at the point of disposal under the SORP

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With the depreciation to be charged from the point of disposal under the SORP to 31 March 2009

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

*Dr Capital Receipts Deferred
Cr Long-Term Debtor*

With the balance on the long-term debtor account as at 31 March 2009

In addition, where the value of the reinstated asset has not been recently revalued (for assets carried at fair value), authorities may need to revalue the asset as at 31 March 2009. Where a revaluation is performed, the entries will be as follows:

*Dr / Cr Property, Plant and Equipment
Cr / Dr Revaluation Reserve (or in the case of the amount of a loss which exceeds the balance on the revaluation reserve, Capital Adjustment Account)*

With the amount of any revaluation

- 10.1.2.50 Authorities would previously have apportioned the income received under the lease into a finance income element and a repayment of principal element. As an operating lease, all income would be recognised in the General Fund; a transfer to the General Fund from the Capital Receipts Reserve (Capital Fund in Scotland) is required unless regulations or statutory guidance require otherwise.

In England and Wales, regulations² require authorities not to classify the capital receipt as General Fund income for leases entered into on or before 31 March 2010, but to retain it as a capital receipt. Consequently, no entries are required.

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance, a transfer from the Capital Fund (Capital Receipts Reserve in Northern Ireland) to the General Fund (District Fund in Northern Ireland) is therefore required. The entries are as follows:

*Dr Capital Fund (Capital Receipts Reserve)
Cr General Fund (District Fund)*

With the amount of income treated as a capital receipt up to 31 March 2009

A worked example is given as scenario A4 in the spreadsheet.

Step 2 - Restate Comparative Figures for 2009/10 (Leases taken out prior to 1 April 2009)

- 10.1.2.51 Where leases have been reclassified as part of step 1, the comparative figures for 2009/10 will also need to be restated to reflect the accounting arrangements for the new lease classification.

Accounting as a Lessee

Operating Lease Reclassified as a Finance Lease

- 10.1.2.52 Where a lease that was classified as an operating lease under the previous SORP has been reclassified as a finance lease under the Code, the charge for the operating lease in the 2009/10 Comprehensive Income and Expenditure Statement will need to be reversed. Depreciation of the asset now recognised under the finance lease shall be accounted for in accordance with the Code. The General Fund shall be charged with the Minimum Revenue Provision (England and Wales) or repayment of the liability (Scotland and Northern Ireland) as required by regulation or statutory guidance.

² The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2010 (SI 2010 No. 454) and The Local Authorities (Capital Finance and Accounting) (Amendment) (Wales) Regulations 2010 (SI 2010 No. 685 (W.67))

Under the SORP, the operating lease payment would have been charged to the General Fund in full. Under the Code, part of the finance lease payment would be allocated to reduce the lease liability. In accordance with BVACOP, the remaining element of the finance lease payment (the interest element) should be reported in Financing and investment income and expenditure rather than the net cost of services. Under the SORP, the operating lease payment would have been charged to the relevant Service Revenue Account. The entries required are as follows:

*Dr Financial Liability
Cr General Fund (Service Revenue Account)*

With the element of the payment that reduces the liability

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account)*

With the interest element of the payment

Depreciation of the asset recognised under the Code should be charged to the appropriate Service Revenue Account where relevant; this will need to be reversed out in the Movement in Reserves Statement and transferred to the Capital Adjustment Account. The entries required are as follows:

*Dr General Fund (Service Revenue Account)
Cr Property, Plant and Equipment*

With the depreciation chargeable for 2009/10

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the reversal of the depreciation

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

Assets recognised under a finance lease on transition to IFRS will normally have been revalued as at 31 March 2009 (Step 1) where a revaluation is required. Where this was not the case, authorities will need to consider whether the asset should be revalued during 2009/10.

In England and Wales, the Local Authority Accounting Panel recommends that the increased MRP that relates to 2009/10 is recognised in the restated 2009/10 accounts, in line with the guidance above under paragraph 10.1.2.45. The entries required are as follows:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP in relation to transactions during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.45, the following entries will be required as part of the MRP charge in 2010/11:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP due from the commencement of the lease until 31 March 2010 (i.e. the element of the payments up to 31 March 2010 that relates to the repayment of the liability)

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability in 2009/10 should be charged to the General Fund (District Fund in Northern Ireland) in the comparative accounts. The entries required are as follows:

*Dr General Fund / District Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the element of the payment in 2009/10 that relates to the repayment of the liability

The worked example in scenario A1 in the spreadsheet includes these transactions.

Finance Lease Reclassified as an Operating Lease

- 10.1.2.53 Where a lease that was classed as a finance lease under the SORP has been reclassified as an operating lease under the SORP, depreciation will need to be reversed and replaced with the charges required under an operating lease. Any Minimum Revenue Provision (England and Wales) or repayment of the liability (Scotland and Northern Ireland) shall be adjusted in accordance with regulations or statutory guidance if required.

Under the SORP, the asset (derecognised in Step 1) would have been subject to depreciation in 2009/10. The depreciation will need to be reversed when restating the 2009/10 Comprehensive Income and Expenditure Statement. The payment under the SORP would have been allocated to a principal element to reduce the liability, and an interest element (reported in financing and investment income and expenditure); under the Code, the operating lease payment would be charged in full to the relevant Service Revenue Account as required under BVACOP. The entries required to restate the 2009/10 accounts are as follows:

*Dr Property, Plant and Equipment
Cr General Fund (Service Revenue Account)*

With the depreciation charged in 2009/10 under the SORP

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the depreciation reversed out of the General Fund in 2009/10 under the SORP

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset under the SORP

*Dr General Fund (Service Revenue Account)
Cr Financial Liability*

With the element of the payment that reduced the liability under the SORP

*Dr General Fund (Service Revenue Account)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the interest element of the payment

In England and Wales, legislation requires authorities to make a prudent MRP charge. It is recommended that the charge in 2010/11 is reduced by the amount of MRP charged in 2009/10 on leases that are reclassified as operating leases; this will be prudent because the amount previously charged as MRP will be recovered through the operating lease charges to the General Fund. The Local Authority Accounting Panel recommends that the portion of the reduction in MRP that relates to transactions during 2009/10 is credited to the General Fund in the comparative 2009/10 accounts, for the reasons set out in the guidance above (under paragraph 10.1.2.46).

Where authorities follow the recommendation above, the following entries will be required:

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the amount charged to the General Fund in respect of MRP during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.46, the following entries will be required as part of the MRP charge in 2010/11:

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the MRP charged in respect of finance lease principal repayments up to 31 March 2010

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the General Fund (District Fund in Northern Ireland) should be credited with the amount charged during 2009/10 in the restated 2009/10 accounts. The entries required are as follows:

*Dr Capital Adjustment Account
Cr General Fund (District Fund) (in the Movement in Reserves Statement)*

With the amount charged to the Fund in respect of finance lease principal repayments during 2009/10

The worked example in scenario A2 in the spreadsheet includes these transactions.

Accounting as a Lessor

Operating Lease Reclassified as a Finance Lease

- 10.1.2.54 Where a lease that was classified as an operating lease under the previous SORP has been reclassified as a finance lease under the Code, charges made in 2009/10 in respect of depreciation will need to be reversed out. Part of the income received in 2009/10 will relate to the repayment of the liability and shall be reclassified as a capital receipt. If regulations or statutory guidance permit the amount now recognised as a capital receipt to be retained in the General Fund, the authority shall report a transfer to the General Fund from the Capital Receipts Reserve (Capital Fund in Scotland) in the Movement in Reserves Statement.

Under the SORP, depreciation would have been charged on the leased asset, as under an operating lease the asset would have remained on the balance sheet. Under the Code, the asset would have been derecognised in Step 1, and the depreciation will need to be reversed. The entries required to restate the 2009/10 comparative accounts are as follows:

*Dr Property, Plant and Equipment
Cr General Fund (Service Revenue Account)*

With the depreciation charged in 2009/10 under the SORP

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the depreciation reversed out of the General Fund in 2009/10 under the SORP

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

Under the SORP, all the income from the operating lease would have been recognised in the Service Revenue Account. Under the Code, an element will be recognised as interest income (reported in financing and investment income and expenditure), whilst the remaining element will be allocated to reduce the long-term debtor. The entries required to restate the 2009/10 comparative accounts are as follows:

*Dr General Fund (Service Revenue Account)
Cr Long-Term Debtor*

With the element of the payment received that reduces the long-term debtor

*Dr General Fund (Service Revenue Account)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the interest element of the payment received

In England and Wales, regulations require authorities not to classify the repayment of the principal element as a capital receipt but to retain it in the General Fund as income. The entries required are as follows:

*Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)*

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund (Capital Receipts Reserve in Northern Ireland). The entries required will be as follows:

*Dr Capital Receipts Deferred
Cr Capital Fund (Capital Receipts Reserve)*

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

The worked example in scenario A3 in the spreadsheet includes these transactions.

Finance Lease Reclassified as an Operating Lease

- 10.1.2.55 Where a lease that was classified as a finance lease under the previous SORP has been reclassified as an operating lease under the Code, the asset (previously treated as disposed of) will still be on the balance sheet, and depreciation charges will be required. Part of the income received in 2009/10 would have been classified as a capital receipt; this will need to be reversed out and credited to the service revenue account. Interest income previously recognised corporately will need to be recognised in the service revenue account (where appropriate). If regulations or statutory guidance require the amount previously recognised as a capital receipt to be retained in the Capital Receipts Reserve (Capital Fund in Scotland), the authority shall report a transfer from the General Fund to the Capital Receipts Reserve (Capital Fund in Scotland) in the Movement in Reserves Statement.

Under the SORP, no depreciation would have been charged as the asset would have been derecognised at the commencement of the finance lease. Under the Code, the asset will have been reinstated as part of Step 1 above, and depreciation will need to be reported in the 2009/10 comparative Comprehensive Income and Expenditure Statement. The entries required to restate the 2009/10 comparative accounts are as follows:

*Dr General Fund (Service Revenue Account)
Cr Property, Plant and Equipment*

With the depreciation due to be charged in 2009/10

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the reversal under regulations / statutory guidance of the depreciation due to be charged in 2009/10

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

Under the SORP, an element of the income would have been recognised as interest income, and the remainder of the income would have reduced the long-term debtor. Under the Code, all the income would be treated as income from an operating lease, and credited to the relevant Service Revenue Account. The entries required to restate the 2009/10 comparative accounts are as follows:

*Dr Long-Term Debtor
Cr General Fund (Service Revenue Account)*

With the amount of the income allocated to the repayment of the long-term debtor during 2009/10

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Receipts Deferred*

With the amount of the income allocated to the repayment of the long-term debtor during 2009/10, and which would have been debited to Capital Receipts Deferred under the SORP

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account)*

With the interest element of the income in 2009/10

In England and Wales, regulations require authorities not to classify the capital receipt as General Fund income for leases entered into on or before 31 March 2010, but to retain it as a capital receipt. Consequently, no entries are required.

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance, a transfer from the Capital Fund (Capital Receipts Reserve in Northern Ireland) to the General Fund (District Fund in Northern Ireland) is therefore required. The entries are as follows:

*Dr Capital Fund (Capital Receipts Reserve)
Cr General Fund (District Fund) (in the Movement in Reserves Statement)*

With the amount of income treated as a capital receipt during 2009/10

The worked example in scenario A4 in the spreadsheet includes these transactions.

Step 3 - Restate Comparative Figures for 2009/10 (Leases taken out during 2009/10)

- 10.1.2.56 Where leases that were taken out during 2009/10 are required to be restated, a similar approach to Step 1 will be required. The opening IFRS Balance Sheet (1 April 2009) will not require amendment, but the 2009/10 Comprehensive Income and Expenditure Statement and the Balance Sheet as at 31 March 2010 shall be restated. Separate entries will be required for the service revenue accounts and corporate accounts (e.g. interest payable) when adjusting the 2009/10 Comprehensive Income and Expenditure Statement.

More detailed adjustments will be required than in Step 1, as the Comprehensive Income and Expenditure Statement as well as the Balance Sheet will require restatement. For example, depreciation adjustments in Step 1 could be made directly between the Capital Adjustment Account and Property, Plant and Equipment as only the 1 April 2009 Balance Sheet was being restated. When restating the 2009/10 comparative accounts, depreciation adjustments will also need to report the transactions in and out of the General Fund. The entries required for each scenario are shown below.

Accounting as a Lessee

Operating Lease Reclassified as a Finance Lease

*Dr Property, Plant and Equipment
Cr Financial Liability*

To recognise the asset and related liability on entering into the lease

*Dr General Fund (Service Revenue Account)
Cr Property, Plant and Equipment*

With any depreciation due on the asset in 2009/10

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the reversal of the depreciation required by the capital financing regime

*Dr Financial Liability
Cr General Fund (Service Revenue Account)*

With the element of any payments in 2009/10 that relates to the reduction of the liability

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account)*

With the interest elements of any payments in 2009/10

In England and Wales, the Local Authority Accounting Panel recommends that the increased MRP in respect of transactions in 2009/10 is recognised in the restated 2009/10 accounts, in line with the guidance above under paragraph 10.1.2.45. The entries required are as follows:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP in relation to transactions during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.45, the following entries will be required as part of the MRP charge in 2010/11:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP due in 2009/10 (i.e. the element of payments in 2009/10 that relates to the repayment of the liability)

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability in 2009/10 should be charged to the General Fund (District Fund in Northern Ireland) in the comparative accounts. The entries required are as follows:

*Dr General Fund / District Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the element of the payment in 2009/10 that relates to the repayment of the liability

The worked example in scenario A1 in the spreadsheet includes these transactions.

In addition, authorities should consider whether the asset should be revalued after initial recognition.

Finance Lease Reclassified as an Operating Lease

*Dr Financial Liability
Cr Property, Plant and Equipment*

With the values recognised on initial recognition; this is to write out the asset and liability from the Balance Sheet

*Dr Property, Plant and Equipment
Cr General Fund (Service Revenue Account)*

With any depreciation charged in 2009/10

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the amount of depreciation reversed in 2009/10 under the SORP

*Dr General Fund (Service Revenue Account)
Cr Financial Liability*

With the amount of any payment in 2009/10 allocated to reduce the liability under the SORP

*Dr General Fund (Service Revenue Account)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the interest element of any payment in 2009/10

If the asset had been revalued in 2009/10 after initial recognition, these entries would also need to be reversed.

In England and Wales, legislation requires authorities to make a prudent MRP charge. It is recommended that the charge in 2010/11 is reduced by the amount of MRP charged in 2009/10 on leases that are reclassified as operating leases; this will be prudent because the amount previously charged as MRP will be recovered through the operating lease charges to the General Fund. The Local Authority Accounting Panel recommends that that the portion of the reduction in MRP that relates to transactions during 2009/10 is credited to the General Fund in the comparative 2009/10 accounts, for the reasons set out in the guidance above (under paragraph 10.1.2.46).

Where authorities follow the recommendation above, the following entries will be required:

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the amount charged to the General Fund in respect of MRP during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.46, the following entries will be required as part of the MRP charge in 2010/11:

Dr Capital Adjustment Account

Cr General Fund (in the Movement in Reserves Statement)

With the amount charged to the General Fund in respect of MRP during 2009/10

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the General Fund (District Fund in Northern Ireland) should be credited with the amount charged during 2009/10 in the restated 2009/10 accounts. The entries required are as follows:

Dr Capital Adjustment Account

Cr General Fund (District Fund) (in the Movement in Reserves Statement)

With the amount charged to the Fund in respect of finance lease principal repayments during 2009/10

The worked example in scenario A2 in the spreadsheet includes these transactions.

Accounting as a Lessor

Operating Lease Reclassified as a Finance Lease

Dr General Fund (Other Operating Expenditure)

Cr Property Plant and Equipment

With the value of the asset at the commencement of the lease

Dr Long-Term Debtor

Cr General Fund (Other Operating Expenditure)

With the initial value of the long-term debtor

Dr Capital Adjustment Account

Cr General Fund (in the Movement in Reserves Statement)

Dr General Fund (in the Movement in Reserves Statement)

Cr Capital Receipts Deferred

To debit or credit the General Fund with any gain or loss on the disposal of the asset by way of a finance lease

Dr Revaluation Reserve

Cr Capital Adjustment Account

With the value in respect of the asset on the Revaluation Reserve

Dr Property, Plant and Equipment

Cr General Fund (Service Revenue Account)

With depreciation charged on the asset under the SORP after the commencement of the lease

Dr General Fund (in the Movement in Reserves Statement)

Cr Capital Adjustment Account

With the reversal of any depreciation charged on the asset under the SORP after the commencement of the lease

Dr Capital Adjustment Account

Cr Revaluation Reserve

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

*Dr General Fund (Service Revenue Account)
Cr Long-Term Debtor*

With the element of any income in 2009/10 allocated to reduce the long-term debtor

*Dr General Fund (Service Revenue Account)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the interest element of any income in 2009/10

In England and Wales, regulations require authorities not to classify the repayment of the principal element as a capital receipt but to retain it in the General Fund as income (where the lease was entered into by 31 March 2010). The entries required are as follows:

*Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)*

With the amount of the income allocated to the repayment of the long-term debtor during 2009/10

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund (Capital Receipts Reserve in Northern Ireland). The entries required will be as follows:

*Dr Capital Receipts Deferred
Cr Capital Fund / Capital Receipts Reserve*

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

The worked example in scenario A3 in the spreadsheet includes these transactions.

Finance Lease Reclassified as an Operating Lease

*Dr Property, Plant and Equipment
Cr General Fund (Other Operating Expenditure)*

With the value of the asset that was written out on disposal under the SORP

*Dr General Fund (Other Operating Expenditure)
Cr Long-Term Debtor*

With the value of the debtor initially recognised at the commencement of the lease

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account
Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)*

To credit or debit the General Fund with the gain or loss on the disposal of the asset recognised under the SORP (the difference between the carrying amount of the asset and the initial value of the long-term debtor, which is recognised as the disposal proceeds)

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the balance on the reserve written out on the disposal of the asset recognised under the SORP

*Dr General Fund (Service Revenue Account)
Cr Property, Plant and Equipment*

With the depreciation due on the asset since the commencement of the lease

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the reversal of the depreciation required by the capital financing regime

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

*Dr Long-Term Debtor
Cr General Fund (Service Revenue Account)*

With the amount of any income previously allocated to reduce the long-term debtor, which under the Code will be operating lease income

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account)*

With the interest element of any income

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Receipts Deferred*

With the amount debited to Capital Receipts Deferred under the SORP

In England and Wales, regulations require authorities not to classify the capital receipt as General Fund income for leases entered into on or before 31 March 2010, but to retain it as a capital receipt. Consequently, no entries are required.

Guidance has yet to be issued in Scotland and Northern Ireland. In Scotland, a decision as to whether statutory guidance will be issued has been deferred until 2010/11, as the Scottish Government is seeking further information from local authorities regarding the possible impact of any reclassification, and this information is not yet available. In the absence of statutory guidance, a transfer from the Capital Fund (Capital Receipts Reserve in Northern Ireland) to the General

Fund (District Fund in Northern Ireland) is therefore required. The entries are as follows:

*Dr Capital Fund (Capital Receipts Reserve)
Cr General Fund (District Fund) (in the Movement in Reserves Statement)*

With the amount of income treated as a capital receipt during 2009/10

The worked example in scenario A4 in the spreadsheet includes these transactions.

B – Finance Lease Income

- 10.1.2.57 Following IAS 17, the Code requires finance income from a finance lease to be calculated so as to produce a constant periodic rate of return on the net investment. Under the 2009 SORP, the finance income was previously calculated so as to give a constant periodic rate of return on the net cash investment. This difference in treatment may lead to income being recognised in different periods, although this is likely to occur infrequently.

Differences between the net investment method and the net cash investment method arise as a result of cash flows to or from a third party (ie from an entity that is not a party to the lease). In the private sector, the most common third party cash flow is taxation payments. This is not relevant to local authorities, although it may be relevant to local authority companies for group accounts purposes.

An example of a third party cash flow that might be relevant to a local authority is a grant to purchase an asset that will subsequently be leased to the private sector (for example, as part of a regeneration project). However, government and other grants are taken into account when calculating both the net investment and net cash investment in a lease. As such, material differences are unlikely to arise.

In the unusual event that a local authority enters into an arrangement where there are third party cash flows (other than government or other grants), the authority should assess the accounting treatment under both methods to ascertain whether the accounting treatment would be materially different.

- 10.1.2.58 Where a lease previously classified as a finance lease continues to be classified as a finance lease under the Code, the finance income for each period from the commencement of the lease shall be calculated so as to produce a constant periodic rate of return on the net investment. Where these amounts are materially different (for an individual lease or in total) from the finance income previously recognised, the General Fund or HRA will need to be debited or credited with the difference, the contra entry being to the long-term debtor. These adjustments will also alter the amount recognised as a capital receipt, and an adjustment will be required between Capital Receipts Unapplied and the Capital Adjustment Account. Adjustments will need to be made both within the 1 April 2009 opening balance sheet and in the restated 2009/10 performance statements and balance sheet.

As discussed above, scenarios where the net investment and net cash investment methods produce materially different amounts are not expected to be common in local authorities, as the differences will arise from third party cash flows (other than government or other grants). The most common example is tax, which is not relevant to a local authority but may be relevant to a local authority company.

Where such leases do exist, the local authority will need to restate the lease, recognising income from the lease over the lease period in accordance with the net investment method.

Authorities should be aware that group accounts need to be based on consistent accounting policies; therefore any leases in other group entities will need to be restated where the income has been assessed on the net cash investment method, and the differences are material.

C – Determining whether an arrangement contains a lease

- 10.1.2.59 For arrangements in place prior to 1 April 2009, an authority shall determine whether the arrangement contains a lease on the basis of the facts and circumstances existing as at that date. For arrangements coming into effect after that date, an authority shall determine whether the arrangement contains a lease on the basis of the facts and circumstances existing as at the inception of the arrangement.

In determining whether an arrangement contains a lease, authorities should refer to section 4.2 of the Code and to IFRIC 4. The following paragraphs from the Code set out the criteria for determining whether an arrangement contains a lease; further guidance can be found in IFRIC 4.

Arrangements containing a lease

4.2.2.25 A local authority may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (eg an item of property, plant or equipment) in return for a payment or series of payments. Authorities shall determine, in accordance with IFRIC 4, whether such arrangements are, or contain, leases that should be accounted for in accordance with this section of the Code and IAS 17. IFRIC 4 applies whether the authority is acting as a lessee or as a lessor.

4.2.2.26 An authority shall not account for such arrangements in accordance with this section of the Code where the agreement falls within the scope of section 4.3 of the Code (PPP and PFI arrangements) or where the arrangement is, or contains, a lease excluded from the scope of this section of the Code and IAS 17.

4.2.2.27 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

- a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset), and*
- b) the arrangement conveys a right to use the asset.*

Fulfilment of the arrangement is dependent on the use of a specific asset

4.2.2.28 Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset.

4.2.2.29 An asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

Arrangement conveys a right to use the asset

4.2.2.30 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

- a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.*
- b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.*
- c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.*

The following is an example of an agreement that may contain a lease. Authorities should note that each arrangement will need to be considered on its own individual circumstances, and that this example should not be taken as meaning that all similar arrangements will be arrangements that contain a lease.

A local authority has entered into a contract with a private sector company for a waste collection service. The contract does not specify the assets to be used for the service, but does specify that any vehicles used in the contract must bear the authority's livery, and that vehicles bearing the authority's livery may only be used to deliver the services in the contract. The authority pays a fixed sum each month, with additional charges should the tonnage collected in the month exceed a specified threshold.

Test 1 - Is fulfilment of the arrangement is dependent on the use of a specific asset or assets?

The contract does not explicitly specify an asset. However, the company is likely to have a limited number of vehicles in the authority's livery, and the requirement that such vehicles are used when delivering the services means that, in this example, "it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets." Test 1 has therefore been met.

Test 2 – Does the arrangement convey the right to use the asset(s)?

The limitations within the contract regarding the use of vehicles in the authority's livery mean that that "it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output" of the asset. The payments under the contract are "neither contractually fixed per unit of output nor equal to the current market price per unit of output." Test 2 has therefore been met.

As both tests have been met, the arrangement contains a lease in accordance with the Code and IFRIC 4, and the authority will need to separate the contract into a lease element and a service element.

The Code and IFRIC 4 include guidance on separating contracts. Authorities should note that it may be necessary to seek information from suppliers to assist with this process. Both the Code and IFRIC 4 include provisions to deal with the situation where it is impracticable to separate the payments reliably.

- 10.1.2.60 Where an arrangement is found to contain a lease, the authority shall recognise any income, expenditure, assets and liabilities (in accordance with section 4.2 of the Code) retrospectively from the commencement of the lease.

Authorities will need to apply IFRIC 4 to arrangements where they are both the purchaser and supplier of services. However, IFRIC 4 is more likely to apply to arrangements where the authority is the purchaser of services.

Where an authority determines that the arrangement includes a lease, the authority will need to determine whether the lease is a finance lease or an operating lease. This test is carried out in accordance with section 4.2 of the Code and IAS 17; the test is the same as for all other leases.

Accounting as a Lessee

Operating Lease

Where the arrangement contains an operating lease, no asset or liability will be recognised on the balance sheet. The opening IFRS Balance Sheet as at 1 April 2009 will not need to be restated. Expenditure during 2009/10 will need to be allocated between payments for services and the operating lease payments for financial reporting purposes. The entries required are as follows:

<i>Dr General Fund (Service Revenue Account – Operating Lease Expense)</i>
<i>Cr General Fund (Service Revenue Account – Services Expense)</i>

With the amount of the payment allocated to the operating lease payments

Finance Leases

Where the arrangement contains a finance lease, the authority will need to recognise an asset and a liability. The process will be to separate the payments into a service element and a lease element; the lease element will then need to be restated. This is similar to the process of a lessee restating an operating lease as a finance lease above. The entries required are as follows:

Step 1 - Restate Opening IFRS Balance Sheet as at 1 April 2009

Authorities will need to recognise the asset and the liability at the inception of the lease in the opening IFRS balance sheet. The entries required are as follows:

<i>Dr Property, Plant and Equipment</i>
<i>Cr Financial Liability</i>

With the fair value of the asset or, if lower, the present value of the minimum lease payments

The element of the previous service payments that relates to the finance lease will need to be restated. The entries required are as follows:

*Dr Financial Liability
Cr General Fund (Service Revenue Account – Expenditure on Services)*

With the element of payments up to 31 March 2009 that relate to the repayment of the liability

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account – Expenditure on Services)*

With the element of payments up to 31 March 2009 that relate to the interest element of the lease (Note that these entries are shown for information only; as only the overall General Fund balance needs to be restated in the opening Balance Sheet, these entries will not be required)

Once recognised as property, plant and equipment, the asset will need to be depreciated in accordance with the authority's accounting policies. As depreciation is not a proper charge to the General Fund under legislation, it would then be reversed out to the Capital Adjustment Account. In restating the opening IFRS balance sheet, the entries required are as follows:

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With the depreciation chargeable from the commencement of the lease until 31 March 2009

The asset will also need to be revalued in accordance with the authority's accounting policies. Where the value of the asset increases, the increase will be credited to the Revaluation Reserve. Where the value of the asset decreases, the decrease would, under the Code, be charged to the General Fund and then transferred to the Capital Adjustment Account. The entries required are therefore as follows:

*Dr Property, Plant and Equipment
Cr Revaluation Reserve*

With any revaluation increase

OR

*Dr Capital Adjustment Account
Cr Property, Plant and Equipment*

With any revaluation decrease

In England and Wales, the statutory guidance recommends that the Minimum Revenue Provision on transition to IFRS (i.e. in 2010/11) is increased by the element of the payments allocated to reduce the liability. The Local Authority Accounting Panel recommends that the increased MRP in respect of transactions up to 31 March 2009 is recognised in the opening 1 April 2009 balance sheet, in line with the guidance above under paragraph 10.1.2.45. The entries required are as follows:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP in relation to transactions up to 31 March 2009

Where an authority does not follow the recommendation above, entries will be required in 2010/11 (see guidance under Step 2 below).

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability up to 31 March 2009 should be charged to the General Fund (District Fund in Northern Ireland) in the opening IFRS Balance Sheet. The entries required are as follows:

Dr General Fund / District Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account

With the element of the payment that relates to the repayment of the liability

A worked example is given as scenario C1 in the spreadsheet.

Step 2 - Restate Comparative Figures for 2009/10 (arrangements taken out prior to 1 April 2009)

Under the SORP, the service payment would have been charged to the General Fund (Service Revenue Account under BVACOP) in full. Under the Code, part of the payment would be treated as a finance lease payment, part of which would be allocated to reduce the lease liability. In accordance with BVACOP, the remaining element of the finance lease payment (the interest element) should be reported in Financing and investment income and expenditure rather than the net cost of services. The entries required are as follows:

Dr Financial Liability
Cr General Fund (Service Revenue Account – Expenditure on Services)

With the element of the payment that reduces the liability

Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account – Expenditure on Services)

With the interest element of the payment

Depreciation of the asset recognised under the Code should be charged to the appropriate Service Revenue Account where relevant; this will need to be reversed out in the Movement in Reserves Statement and transferred to the Capital Adjustment Account. The entries required are as follows:

Dr General Fund (Service Revenue Account – Depreciation)
Cr Property, Plant and Equipment

With the depreciation chargeable for 2009/10

Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)

With the reversal of the depreciation

Dr Revaluation Reserve
Cr Capital Adjustment Account

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset

Assets recognised under a finance lease on transition to IFRS will normally have been revalued as at 31 March 2009 (Step 1) where a revaluation is required.

Where this was not the case, authorities will need to consider whether the asset should be revalued during 2009/10.

In England and Wales, the statutory guidance recommends that the Minimum Revenue Provision on transition to IFRS (i.e. in 2010/11) is increased by the element of the payments allocated to reduce the liability. The Local Authority Accounting Panel recommends that the increased MRP in respect of transactions in 2009/10 is recognised in the restated 2009/10 accounts, in line with the guidance above under paragraph 10.1.2.45. The entries required are as follows:

Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account

With MRP in relation to transactions during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.45, the following entries will be required as part of the MRP charge in 2010/11:

Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account

With MRP due from the commencement of the lease until 31 March 2010 (ie the element of the payments up to 31 March 2010 that relates to the repayment of the liability)

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability in 2009/10 should be charged to the General Fund (District Fund in Northern Ireland) in the comparative accounts. The entries required are as follows:

Dr General Fund / District Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account

With the element of the payment in 2009/10 that relates to the repayment of the liability

A worked example is given as scenario C1 in the spreadsheet.

Step 3 - Restate Comparative Figures for 2009/10 (Arrangements entered into during 2009/10)

Where arrangements entered into during 2009/10 require restatement, a similar approach to that used in Step 1 will be required. However, more detailed adjustments will be required than in Step 1, as the Comprehensive Income and Expenditure Statement as well as the Balance Sheet will require restatement. For example, depreciation adjustments in Step 1 could be made directly between the Capital Adjustment Account and Property, Plant and Equipment as only the 1 April 2009 Balance Sheet was being restated. When restating the 2009/10 comparative accounts, depreciation adjustments will also need to report the transactions in and out of the General Fund. The entries required are as follows:

Dr Property, Plant and Equipment
Cr Financial Liability

To recognise the asset and related liability on entering into the lease

*Dr General Fund (Service Revenue Account - Depreciation)
Cr Property, Plant and Equipment*

With any depreciation due on the asset in 2009/10

*Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

With the reversal of the depreciation required by the capital financing regime

*Dr Financial Liability
Cr General Fund (Service Revenue Account – Expenditure on Services)*

With the element of any payments in 2009/10 that relates to the reduction of the liability

*Dr General Fund (Financing and Investment Income and Expenditure)
Cr General Fund (Service Revenue Account – Expenditure on Services)*

With the interest elements of any payments in 2009/10

In England and Wales, the statutory guidance recommends that the Minimum Revenue Provision on transition to IFRS (i.e. in 2010/11) is increased by the element of the payments allocated to reduce the liability. The Local Authority Accounting Panel recommends that the increased MRP in respect of transactions in 2009/10 is recognised in the restated 2009/10 accounts, in line with the guidance above under paragraph 10.1.2.45. The entries required are as follows:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP in relation to transactions during 2009/10

If authorities choose not to follow the guidance under paragraph 10.1.2.45, the following entries will be required as part of the MRP charge in 2010/11:

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With MRP due in 2009/10 (ie the element of payments in 2009/10 that relates to the repayment of the liability)

In Scotland and Northern Ireland, finance leases are accounted for outside the Loans Fund, and the repayment of the liability in 2009/10 should be charged to the General Fund (District Fund in Northern Ireland) in the comparative accounts. The entries required are as follows:

*Dr General Fund / District Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the element of the payment in 2009/10 that relates to the repayment of the liability

In addition, authorities should consider whether the asset should be revalued after initial recognition.

A worked example is given as scenario C1 in the spreadsheet.

Accounting as a Lessor

Operating Lease

Where the arrangement contains an operating lease, the asset will remain on the balance sheet and no long-term debtor will be recognised. The opening IFRS Balance Sheet as at 1 April 2009 will therefore not need to be restated. Income during 2009/10 will need to be allocated between income in respect of services provided and the operating lease income for financial reporting purposes. The entries required are as follows:

Dr General Fund (Service Revenue Account – Income from Services)
Cr General Fund (Service Revenue Account – Operating Lease Income)

With the amount of the income allocated to the operating lease

Finance Leases

Where the arrangement contains a finance lease, the authority will need to derecognise the asset and recognise a long-term debtor. The process will be to separate the income into a service element and a lease element; the lease element will then need to be restated. This is similar to the process of a lessor restating an operating lease as a finance lease above. The entries required are as follows:

Step 1 - Restate Opening IFRS Balance Sheet as at 1 April 2009

Where the arrangement contains a finance lease under the Code, authorities will need to derecognise the asset they would have been carrying in their balance sheet under the SORP, and recognise a long-term debtor reflecting the other party's obligation to make lease payments to the authority. Under the SORP, service income would have been credited to the General Fund (Service Revenue Account); under the Code this income will need to be allocated to an interest element (credited to the General Fund – Financing and Investment Income and Expenditure) and an element that reduces the long term debtor. The entries required are as follows:

Dr Capital Adjustment Account
Cr Property, Plant and Equipment

With the carrying amount of the leased asset

Dr Revaluation Reserve
Cr Capital Adjustment Account

With any balance on the Revaluation Reserve in respect of the leased asset

Dr Long-Term Debtor
Cr Capital Receipts Deferred

With the initial value of the long-term debtor (the amount recognised as the disposal proceeds)

Dr General Fund (Service Revenue Account – Income from Services)
Cr Long-Term Debtor

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

*Dr General Fund (Service Revenue Account – Income from Services)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the element of income up to 31 March 2009 that relates to the interest element of the lease (Note that these entries are shown for information only; as only the overall General Fund balance needs to be restated in the opening Balance Sheet, these entries will not be required)

In England and Wales, regulations will allow authorities not to classify the repayment of the principal element as a capital receipt but to retain it in the General Fund as income. The entries required are as follows:

*Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)*

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

Guidance has yet to be issued in Scotland and Northern Ireland. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund (Capital Receipts Reserve in Northern Ireland). The entries required will be as follows:

*Dr Capital Receipts Deferred
Cr Capital Fund / Capital Receipts Reserve*

With the amount of the payments allocated to the repayment of the long-term debtor up to 31 March 2009

A worked example is given as scenario C2 in the spreadsheet.

Step 2 - Restate Comparative Figures for 2009/10 (arrangements taken out prior to 1 April 2009)

Under the SORP, depreciation would have been charged on the leased asset, as the asset would have remained on the balance sheet. Under the Code, the asset would have been derecognised in Step 1, and the depreciation will need to be reversed. The entries required to restate the 2009/10 comparative accounts are as follows:

*Dr Property, Plant and Equipment
Cr General Fund (Service Revenue Account - Depreciation)*

With the depreciation charged in 2009/10 under the SORP

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the depreciation reversed out of the General Fund in 2009/10 under the SORP

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset under the SORP

Under the SORP, all the income from the arrangement would have been recognised as income from services in the Service Revenue Account. Under the Code, part of the income will be reclassified as finance lease income. An element of the finance lease income will be recognised as interest income (reported in financing and

investment income and expenditure), whilst the remaining element will be allocated to reduce the long-term debtor. The entries required to restate the 2009/10 comparative accounts are as follows:

Dr General Fund (Service Revenue Account – Income from Services)
Cr Long-Term Debtor

With the element of the payment received that reduces the long-term debtor

Dr General Fund (Service Revenue Account – Income from Services)
Cr General Fund (Financing and Investment Income and Expenditure)

With the interest element of the payment received

In England and Wales, regulations will allow authorities not to classify the repayment of the principal element as a capital receipt but to retain it in the General Fund as income. The entries required are as follows:

Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

Guidance has yet to be issued in Scotland and Northern Ireland. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund (Capital Receipts Reserve in Northern Ireland). The entries required will be as follows:

Dr Capital Receipts Deferred
Cr Capital Fund / Capital Receipts Reserve

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

A worked example is given as scenario C2 in the spreadsheet.

Step 3 - Restate Comparative Figures for 2009/10 (Arrangements taken out during 2009/10)

Where arrangements taken out during 2009/10 require restatement, a similar approach to that used in Step 1 will be required. However, more detailed adjustments will be required than in Step 1, as the Comprehensive Income and Expenditure Statement as well as the Balance Sheet will require restatement. For example, derecognition of the asset in Step 1 could be made directly between the Capital Adjustment Account and Property, Plant and Equipment as only the 1 April 2009 Balance Sheet was being restated. When restating the 2009/10 comparative accounts, the derecognition transactions will also need to report the transactions in and out of the General Fund. The entries required for each scenario are shown below.

Dr General Fund (Other Operating Expenditure)
Cr Property Plant and Equipment

With the value of the asset at the commencement of the lease

*Dr Long-Term Debtor
Cr General Fund (Other Operating Expenditure)*

With the initial value of the long-term debtor

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Receipts Deferred
Dr Capital Adjustment Account
Cr General Fund (in the Movement in Reserves Statement)*

To debit or credit the General Fund with any gain or loss on the disposal of the asset by way of a finance lease (the difference between the carrying amount of the asset and the initial value of the long-term debtor, which is recognised as the disposal proceeds)

*Dr Revaluation Reserve
Cr Capital Adjustment Account*

With the value in respect of the asset on the Revaluation Reserve

*Dr Property, Plant and Equipment
Cr General Fund (Service Revenue Account - Depreciation)*

With depreciation charged on the asset under the SORP after the commencement of the lease

*Dr General Fund (in the Movement in Reserves Statement)
Cr Capital Adjustment Account*

With the reversal of any depreciation charged on the asset under the SORP after the commencement of the lease

*Dr Capital Adjustment Account
Cr Revaluation Reserve*

With the depreciation adjustment required in respect of any depreciation on the revalued portion of the carrying amount of the asset under the SORP

*Dr General Fund (Service Revenue Account – Income from Services)
Cr Long-Term Debtor*

With the element of any income in 2009/10 allocated to reduce the long-term debtor

*Dr General Fund (Service Revenue Account – Income from Services)
Cr General Fund (Financing and Investment Income and Expenditure)*

With the interest element of any income in 2009/10

In England and Wales, regulations will allow authorities not to classify the repayment of the principal element as a capital receipt but to retain it in the General Fund as income (where the lease was entered into by the date specified in the regulations, which is 31 March 2010). The entries required are as follows:

*Dr Capital Receipts Deferred
Cr General Fund (in the Movement in Reserves Statement)*

With the amount of the income allocated to the repayment of the long-term debtor during 2009/10

Guidance has yet to be issued in Scotland and Northern Ireland. In the absence of statutory guidance or an accounts direction, the repayment of the principal element will be credited to the Capital Fund (Capital Receipts Reserve in Northern Ireland). The entries required will be as follows:

*Dr Capital Receipts Deferred
Cr Capital Fund / Capital Receipts Reserve*

With the amount of the payments allocated to the repayment of the long-term debtor during 2009/10

A worked example is given as scenario C2 in the spreadsheet.

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