Transition arrangements – Leases

A - Reclassification of Leases

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

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.

Separation of Land and Buildings Leases

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.

Lease Reclassification – Accounting as a Lessee

Operating Lease Reclassified as a Finance Lease

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 equivalent PWLB annuity rate shall be used.

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.

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.

The General Fund shall be charged with MRP / Loans Fund Charges payable from the inception of the lease until 31 March 2009.

Finance Lease Reclassified as an Operating Lease

Where a finance lease is reclassified as an operating lease, the asset and liability will need to be derecognised. Adjustments will also be required in respect of MRP / Loans Fund charges to the General Fund that have previously been accounted for. This may result in a difference between the amount previously charged to the General Fund for MRP / Loans Charges and the amount that would have been charged under an operating lease.

For each lease, authorities will need to calculate what the cumulative charges to the General Fund under an operating lease would have been. This is compared to the cumulative charges actually made in respect of interest under the lease and MRP / Loans Fund Charges (plus any voluntary contributions that were made in respect of the lease). The difference is debited or credited (as appropriate) to the General Fund so that the General Fund balance reflects the position as if the lease had always been accounted for as an operating lease.

Lease Reclassification – Accounting as a Lessor

Operating Lease Reclassified as a Finance Lease

Where an operating lease is reclassified as a finance lease, the asset shall be derecognised and a long-term debtor recognised.

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.

Finance Lease Reclassified as an Operating Lease

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.

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.

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

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

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 Income and Expenditure Account will need to be reversed. Depreciation of the asset now recognised under the finance lease along with MRP where appropriate shall be accounted for in accordance with the Code.

Finance Lease Reclassified as an Operating Lease

Where a lease that was classed as a finance lease under the SORP has been reclassified as an operating lease under the SORP, the capital financing entries (depreciation, MRP etc.) will need to be reversed and replaced with the charges required under an operating lease.

Accounting as a Lessor

Operating Lease Reclassified as a Finance Lease

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.

Finance Lease Reclassified as an Operating Lease

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).

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

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 performance statements 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 performance statements.

B – Finance Lease Income

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.

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.