



# Accounting for leases

Why it affects you



## Background

From 1 April 2020, the NHS will change the way that it accounts for leases. This is not an NHS specific change – the private sector adopted the new accounting standard from 1 April 2019 with the public sector catching up a year later.

Most changes to accounting standards are managed by the finance department and have very little impact on the rest of the organisation. However, this is different. Everyone who is able to enter into a contract that includes the use of an asset needs to be aware that the contract may contain a lease. This is because the new accounting arrangements will impact on the financial position of the NHS organisation. This briefing is aimed at non-finance staff and non-executive directors. The HFMA has produced a technical briefing<sup>1</sup> for its members which explains the issue in more detail.

## What is a lease?

The new accounting standard<sup>2</sup> defines a contract as follows:

A lease is a contract, or part of a contract, which conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration.

<sup>1</sup> HFMA, *Accounting for leases – application of IFRS 16*, updated July 2019

<sup>2</sup> The standard is one of the International Financial Reporting Standards (IFRS), accountants are likely to refer to it as IFRS 16 *Leases*

### Example

An NHS organisation enters into a contract with Supplier Ltd for the provision of an ambulance for five years. The ambulance is fitted to the NHS organisation's specification and branded with its livery. The NHS body determines when and where the ambulance is used, it is stored in the NHS body's garage and only the NHS organisation's staff drive it.

If the ambulance needs to be repaired and will be off the road for more than two days, Supplier Ltd is responsible for replacing it with a suitable alternative while the repair is taking place. Otherwise, Supplier Ltd cannot retrieve the ambulance or substitute it for another one until the end of the contract. **This contract contains a lease.**

## So, what is changing?

From 1 April 2020, all leases will be accounted for 'on-balance sheet'. This means that when the lease contract starts the NHS body will include on its balance sheet<sup>3</sup>:

- a right-of-use asset that reflects the fact that the NHS body has the right to use the underlying asset for the period of the lease, and
- a liability that reflects the fact that it has to pay for that asset over the period of the lease.

The NHS body will still make cash payments over the life of the lease in accordance with the contract.

Currently, leases are split into two types – finance and operating. Only finance leases are accounted for 'on-balance sheet' so accounting for these will not change as a result of the new accounting requirements. For operating leases, however, payments to the lessor are charged to the income and expenditure account as they are made. In the example above, if the ambulance was expected to have a useful life of, say, 10 years and Supplier Ltd expected that it could either sell or lease the vehicle at the end of the five-year contract then the lease would probably have been accounted for as an operating lease, so it would have simply been an expense over the five years of the contract.

Until now, the critical question asked by accountants in relation to contracts that include leases was always 'is it an operating or a finance lease?' or even just 'is it a finance lease?'. From now on, the critical question will be 'does that contract contain a lease?'

## Why does it affect non-accountants?

Any contract that includes reference to the use of an asset might be a lease. Therefore, anyone who has authority to enter into contracts should be aware of the new accounting arrangements so they can ask a member of the finance team to decide whether it includes a lease.

### Example

An NHS organisation enters into a three-year contract with Supplier Ltd for the supply of test results. The contract states that the samples sent by the NHS body for testing will be run through a specific machine which is hosted on Supplier Ltd's site. The contract states that the NHS body has the rights to all of the output of that machine so, if there are no samples from the NHS organisation to be tested then the machine is not used. Supplier Ltd operates and maintains the machine in accordance with industry approved operating practices.

While this arrangement is for the supply of test results, **this contract contains a lease**, because the NHS body has the right to substantially all of the benefit of the machine for the three-year contract and the NHS body directs the use of the machine.

The change to the accounting arrangements means that leases will impact on NHS organisations' financial statements differently. There are two main impacts – firstly, on capital resources but, secondly, on the surplus/deficit reported each year and therefore on budgets.

<sup>3</sup> This is also called the statement of financial position

## Impact on capital

From 1 April 2020, all leases will count as capital expenditure – in essence, capital expenditure is money spent on assets that will be used by the NHS organisation for more than a year. Usually, these are tangible assets such as equipment, buildings and vehicles.

Under the current arrangement only finance leases count as capital expenditure. For the NHS as a whole, the amount of capital expenditure that can be incurred is limited by the capital departmental resource limit (CDEL). The CDEL reflects the amount of money that Parliament has voted for the Department of Health and Social Care/ Scottish Government/ Welsh Government/ Northern Ireland Assembly to spend on capital and is therefore a statutory limit.

As only finance leases count as capital expenditure at the moment, this means that there has been much less reason to monitor and track operating leases in the NHS. Contracts such as managed service contracts are probably leases, but may not be recorded on a central lease register.

### Example

An NHS foundation trust enters into a managed service contract with the supplier of pathology equipment to provide test results. The equipment is located in the trust's labs and is used by trust staff who are the only people who have access to those labs. The trust pays for the consumables needed to run the equipment under the contract terms and has no option to buy them elsewhere.

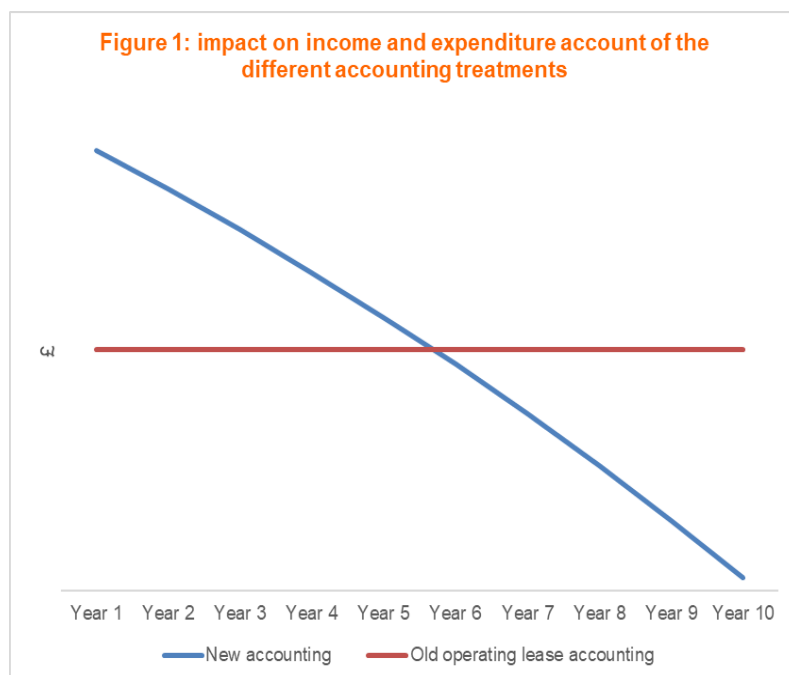
The trust has the right to control the use of the equipment (it is in its lab and used only by its staff) and pays for that right through the purchase of consumables. Although the supplier has the right to replace the equipment at its own cost, it is highly unlikely that this would happen as it does not make commercial sense. **This contract contains a lease.**

HM Treasury has indicated that CDEL will not be affected by leases (operating or finance) entered into before 31 March 2020 – so before the new accounting treatment takes effect. For leases entered into after 1 April 2020, HM Treasury has said that there will be a compensating adjustment to CDEL to take account of the new accounting arrangements. However, the detail is complicated, and no-one has yet quantified the effect of the new standard on CDEL.

## Impact on revenue

Currently the costs of operating leases are expensed as they are incurred. So, usually this is on a straight line over the length of the lease (the red line in **figure 1**).

Under the new arrangements, the asset reflecting the right to use the asset will be depreciated over the length of the lease (again on a straight line basis) but there will be an interest charge to pay on the liability to make payments to the lessor. The interest charges will be higher at the start of the lease than at the end because the liability will be reduced as payments are made to the lessor (the blue line in **figure 1**). So, while the total cost of the asset and the cash leaving the bank will not change, there will be a bigger hit to the expenditure in the earlier years and a lower hit in later years.



## Is there any wriggle room?

Leases for assets of low value and of less than a year in length are not accounted for on-balance sheet. However, the standard does not define low value other than to suggest that it is items such as phones, tablets and photocopiers that have a value of less than \$5,000<sup>4</sup> when new.

Other than that, the standard requires that the most likely, commercially sensible option is taken. Basically, if a lot of work has to be done to try to conclude that the contract is not a lease then it probably is a lease!

## What has to be done and by when?

The 2019/20 accounts will include disclosures in relation to current operating and finance leases and these will be the basis for the new accounting arrangements on 1 April 2020.

The 2020/21 plans will need to be developed on the new accounting basis. These will be developed in early 2020.

This means that by the end of 2019 the finance team will need to ensure that they are aware of all existing leases, which will involve reviewing existing contracts and arrangements that have not already been assessed against current accounting standards. They will also have to design new arrangements to identify and record all leases going forward. This is likely to involve a change to current financial reporting/ management processes.

## Questions to ask the finance team

Depending on your role, you may want to discuss this with financial accounting colleagues and ask them questions such as:

- I'm about to sign a contract for the provision of a service, but the contract says that there is an asset that will be used to deliver that service – do you want to look at it before I sign it?
- I'm putting together a business case for a new piece of kit, please can you help me put the numbers together for the financial impact?
- the contract says it's not a lease, but it's for the use of a specified asset, could it be a lease?
- I'm thinking about my budget for 2020/21, does it need to be changed to reflect the cost of all of these operating leases?
- I'm a non-executive director on the audit committee, should this issue be on our agenda?

The answer to all of these questions should be yes!

## Further information

HFMA, [Accounting for leases - application of IFRS 16](#), July 2019

HFMA, [Webinar](#), 28 November 2018

HFMA, [Webinar](#), 18 July 2019

HFMA, [Webinar](#), 13 November 2019

HM Treasury, [IFRS 16 leases: application guidance](#), 2018 (updated April 2109)

DHSC, [Group accounting manual: IFRS 16 supplement](#), January 2019

HM Treasury, [IFRS 16 Leases: supplementary budgeting guidance](#), July 2019

NHS Improvement, [IFRS 16 implementation guide](#), September 2019

NHS Improvement, [IFRS 16 FAQ](#), regularly updated

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<sup>4</sup> This is US dollars – it is not intended to be an absolute limit so organisations will have to determine their own threshold for low value assets.

## About the HFMA

The Healthcare Financial Management Association (HFMA) is the professional body for finance staff working in healthcare. For 70 years it has provided independent support and guidance to its members and the wider healthcare community.

It is a charitable organisation that promotes the highest professional standards and innovation in financial management and governance across the UK health economy through its local and national networks. The association analyses and responds to national policy and aims to exert influence in shaping the healthcare agenda. It also works with other organisations with shared aims in order to promote financial management and governance approaches that really are 'fit for purpose' and effective.

The HFMA is the biggest provider of healthcare finance and business education and training in the UK. It offers a range of qualifications in healthcare business and finance at undergraduate and postgraduate level and can provide a route to an MBA in healthcare finance. The association is also an accredited provider of continuing professional development, delivered through a range of events, e-learning and training. In 2019 the HFMA was approved as a main training provider on the Register of Apprenticeship Training Providers and will be offering and developing a range of apprenticeships aimed at healthcare staff from 2020.

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