



Foundation Trust Network Comment Letter to the Exposure Draft on Leases

December 2010

1. Introduction

The Foundation Trust Network (FTN) was established as part of the NHS Confederation to provide a distinct voice for NHS foundation trusts (UK public hospitals). We work to raise the profile of the issues facing existing and aspirant foundation trusts and to improve the influence of FTN members.

2. The foundation trust model

Foundation trusts are:

- a new type of NHS (National Health Service) organisation established in 2003 as public benefit corporations;
- accountable to their local communities through a system of local ownership with members and elected governors - the governors being elected by the members;
- not required to break even each year although they must be financially viable. They can borrow money within limits set by the regulator, retain surpluses and decide on service development for their local populations;
- free from central government control and strategic health authority performance management;
- required to lay their annual reports and accounts before Parliament each year.

3. Comments on the exposure draft

General comment

The below comments are a selection of those received from multiple Foundation Trust hospitals reflecting the views of our members on the proposals.

There are overall concerns about the extra costs that these changes may incur on organisations for example in assessing leases and lease type arrangements in preparation for the proposed standards. It is also likely that there will be recurrent costs as more work will be required to assess and audit potential lease type arrangements.

A fundamental aspect of leasing within the NHS is that a corporate lessor can take advantage of capital allowances the financial implication of which is ultimately reflected to some extent in lower lease payments. If lessors are required to recognise the derecognition of assets it is not clear what the implications would be on capital charge allowances. If capital allowances are no longer claimable then this is likely to result in increased lease costs particularly in the non for profit sector where entities may not be able to take the benefit of capital allowances themselves.

Private Finance Initiative

An area of great concern for Foundation Trusts is how this will effect Private Finance Initiative (PFI) schemes. Comments included:

- 1) Currently PFI type arrangements are dealt with by applying IFRIC 12 and where infrastructure should be recognised, IAS 17 and then IAS 16. It is not clear within the ED how PFI arrangements will be accounted for and whether IFRIC 12 will be withdraw.

Under the proposed ED it is possible that PFI infrastructure will be recognised as an in substance purchase and therefore dealt with by the application of standards such as IAS 16 and IAS 39.

The ED seems to be deficient regarding the accounting treatment of PFI arrangements and should be strengthened to provide clear unambiguous guidance.

- 2) The ED is not clear as to the applicability to PFI schemes and we would wish to see further clarity around the accounting for contingent rentals. Our current accounting treatment is in line with DH/IFRS guidance whereby contingent rentals are expensed in the year in which they occur.

The ED suggests that we should include an assessment of future contingent rentals based on a probability weighted estimate of the future change in rentals e.g. interest rate at inception. This would then be added to the lease liability. In addition in each financial year an assessment would need to be carried out of the actual contingent rental and the difference between this and the amount estimated should be expensed in that year. If this is the case then it could have a significant impact on Income & Expenditure (variable amount charged each year for contingent rental), Balance Sheet (increased Lease Liability) and for the Trust's Prudential Borrowing Limit as an increase in lease liability would count against it. As PFI schemes are over a significant period of time this could have a major impact on Trust finances. Also would the adjustment be retrospective?

The other comment I have is with regard to initial direct costs to be included when assessing the lease liability. The DH guidance on PFI IFRS transition made it clear that only costs relating to the initial cost of the asset could be recognised in the lease liability whereas the ED suggests other associated costs could be included. This would therefore mean that PFI Lease Liabilities could increase as a consequence.

Q1 and Q2 Lessees and Lessors

It is important that the accounting treatment of Lessees and Lessor is equal and opposite to avoid the previous situations of assets being recognised on both balance sheets (On On) or on neither balance sheet (Off Off).

As regards Q1a) some members do not agree because many right of use assets are of a minor value e.g photocopiers and organisation should be able to set de-minimus levels – this links to Question 5 Scope exclusions

Q3 Short term leases

The proposed accounting treatment within the ED appears to be inappropriate for accounting for short term lease. Short term leases should be charged directly to the statement of comprehensive income in such a manner that the charge should be evenly distributed across the term of the arrangement.

Another member commented that:

This action creates a double entry on the SoFP and over the 12 month period charges out/credits P&L with equal and opposite values so has no impact on bottom line surplus/deficit. If the lessor opted to retain the asset on its SoFP as per part B both lessee and lessor would have the same asset on their SoFP. My preference is to allow all short term leases of 12 months or less to be directly charged to revenue for the full lease payment.

Q4 Managed service contract

The proposal appears to imply that if an entity is unable to identify the service component of a managed service contract it should treat the transaction as a lease. By definition such transactions normally involve the provision of both assets and services. Assets should be dealt with through an entities balance sheet and the revenue service element through the statement of comprehensive income (SCI).

It would therefore seem wholly inappropriate that that the service element should be treated as a lease.

The accounting treatment contained within the current IFRIC 4 seems more appropriate in that a managed service contract should be primarily be recognised as a revenue transaction that should be charge through the SCI. Where an entity can identify a separately identifiable asset within the arrangement then this should be separately dealt with as a lease.

Q5 Scope exclusions

Organisations should be able to set de-minimus levels (if not already able to under existing standards)

Q6 Contracts that contain service components and lease components

Some foundation trusts disagree with the proposed approach. One commented:

Many contract contain a service element which might not be readily identifiable. If this method was applied the organisation would create an asset for a service rather than a physical asset. How would this asset be revalued? I believe a notional split should be used based on the fair value of the actual asset in use and this value depreciated based on the lease term versus the estimated full life of the asset. Say for example a contract of £10k per year includes a service element and the contract is for 5 years. The estimated full life is 10 years and has a fair value of £30k. Broadly value of the asset after 5 years is £15k. The NPV of the rentals could be £35k. Ignoring interest the service element over 5 years is £20k. So the asset value is recorded at £15k with the balance of the rentals £20k charge to P&L

Q7 Purchase Options

In practical execution of a purchase option a situation could arise whereby such an option is exercised with a notice period such that the asset is not strictly "purchased" until a date in the future. The asset should not be recognised at the time the option is exercised but when the asset comes under the unfettered control of the purchasing organisation.

Q8 Lease Term

Multiple foundation trusts disagreed with this proposed approach in part due to the difficulty in identifying which inevitably will be subjective and hence could lead to inconsistencies. Comments included:

- 1) We do not agree that the lease term should be determined by identifying the longest possible term that is **more likely** that not to occur. The lease term should be determined by identifying the longest possible term that is either **reasonably certain** or **virtually certain** to occur. As well as being much easier to identify it will also be easier to provide audit evidence to support this position.
- 2) I think another simple method should be established but if still required I believe the calculation should be based on normal provisions accounting organisation should use average life based on range of probabilities.

e.g.	Probability of 5 year term	20%
	Probability of 7 year term	50%
	Probability of 10 year term	30%

Expected life = $(5*0.2+7*0.5+10*0.30) = 7.5$ years
- 3) Both parties should consider the term of the lease as the longest term and review it after the expiry of the primary lease term. Otherwise, both parties could end up carrying values which may not reflect the fair value, particularly when technology is advancing at a great pace.

Question 10

One foundation trust respondent identified an issue here which is not covered by the question but nevertheless applies which relates to the revaluation of the right of use asset.

Under paragraph 20 of the draft the asset is amortised initially over the shorter of the lease term or useful life if lower.

Under paragraph 21 the lessee "may" revalue the asset at fair value but if it revalues that asset class it would have to revalue the asset. There is no reference to changing the life of the asset. In this case assets which are leased over a short term but have a significant value e.g. building leases would be revalued at their full market value but amortised over the shorter lease term. This would give organisations excessive charges to P&L.

For example:

A building is leased for 5 years at a rental of 10k per annum. Its market value is £500k. Broadly speaking the asset would initially be recognised at say £45k (NPV) with a life of 5 years. If the organisation revalued all its buildings it would need to revalue this asset to £500k but still depreciate it over 5 years i.e. £100k per annum compared to the lease rental of £10k per annum. (The NHS would also pay a 3.5% dividend charge) Essentially it is charging P&L for the full value of the asset over a short period although that building will have a 50 year life. This would have a huge impact on P&L (not cash).

The answer is to either not to require revaluation of leased assets (my preference) or to give the building a life based on its full estimated remaining life.

Question 12, 13 and 14

We do not agree that an entity separately identify leased assets within its statement of financial position, SCI or cashflow. Leasing is merely a funding mechanism and if all leased assets are now recorded in the SFC they will be accounted for the same way as purchased assets, assets acquired under HP or lease purchase arrangements.

It seems inappropriate that detailed information regarding leased assets should be separately identified in the main financial statement but instead should be dealt with by suitable disclosure in notes to the accounts.

Accordingly why should leased assets be separately recognised within the key financial statements simply because they have been funded differently to capital purchase or HP acquired assets?