



## Understanding leasing

When it comes to determining the most appropriate equipment leasing strategy for your school, understanding the main differences between a finance lease and an operating lease is essential. In both cases, the assets or equipment is legally owned by the lessor during the lease term, with rentals paid by the school in order to use the equipment. There are however key differences that you need to know about and this factsheet outlines those.

**Important note: An operating lease is the only type of lease agreement that state funded schools (local authority or Academy) can enter into without prior approval. In order to enter into a finance lease, trusts must obtain prior approval from EFA.**

**No other form of finance (such as hire purchase) may be entered into by a school as this is a prohibited form of borrowing**

### Operating Lease:

- An Operating Lease requires the school to pay only a proportion of the capital value of the equipment and over a shorter agreement term, classed usually as the equipment's 'useful economic life.'
- With an operating lease you will only finance a percentage of the total cost of the equipment over the term of the lease, as the provider of the finance must retain a proportion of the original cost, known as the Residual Value.
- As part of the current accountancy regulations, the funder is required to take 'sufficient risk' in the lease. Most auditors will use the '90% test' to establish this. This is not written in to current regulations but is a good guideline. What it means is the lease rentals paid under the primary lease must not exceed 90% of the original capital cost. When working out the '90% test' auditors exclude the interest to work out how much capital is being repaid – it's important not to simply add up your rentals
- The length of the agreement should not exceed the expected 'useful economic life' of the equipment (equipment such as MFDs and photocopiers typically have a useful life of 3-4 years). If you are offered longer, consider the expected whole life of the asset and lease for a term which represents a proportion of this
- At the end of the agreed lease term, the school can choose to either return the equipment or continue with the rental agreement but be mindful of the point above on "useful life" of equipment. The ownership of the asset should remain with the leasing company. There should be no option for the school to gain ownership of the asset at any time.
- The leasing company might retain responsibility for maintenance
- Payments are shown on the profit and loss account and not the balance sheet due to the nature of the payments

- Further details of an operating lease can be found under the relevant accountancy regulation SSAP 21 Accounting for leases and hire purchase contracts. Note that for any accounting periods commencing on or after 1 January 2015, this standard will be replaced by the new UK standard, FRS 102. The impact of this in relation to leases will be minimal. FRS 102 takes a risks and rewards approach to the classification of leases, as does SSAP 21, however under FRS 102, the 90% test noted above is no longer relevant.

### Finance Lease:

- The finance company or lessor is the legal owner of the asset yet will permit the school to have use of that asset during the lease, paid for via a series of rentals or instalments over an agreed term.
- A finance lease is a form of borrowing, where 100% of the capital plus interest is repaid during the primary term
- The school has the option to keep the asset by either paying the last rental or in some cases, paying a nominal fee or a significantly reduced purchase price.
- Under a finance lease, the school repays rentals over the term of the lease but the rentals are not discounted. During the lease term the total rentals will normally cover the value of the asset

### Questions to ask about finance and operating leases

If you are not sure about the type of lease being offered, it is worth asking the following questions using the tables below in order to find out more.

#### Questions to ask to ascertain whether the lease is operating or finance

	Answer	Answer
Does the lease transfer ownership of the asset to the lessee (i.e. the school) by the end of the lease term?	Yes - finance lease	No - operating lease
Does the lessee have the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised?	Yes - finance lease	No - operating lease
Is the lease term for the major part of the economic life of the asset, even if title is not transferred?	Yes - finance lease	No - operating lease
At the inception of the lease does the Net Present Value of the minimum lease payments amount to at least substantially all of the fair value of the leased asset?	Yes - finance lease	No - operating lease
Are the leased assets of a specialised nature such that only the lessee can use them without major modifications being made?	Yes - finance lease	No - operating lease

**If still unsure as to type of lease, i.e. a mix of yes and no answers to the section above, consider the next set of questions:**

	Answer	Answer
If the lessee is entitled to cancel the lease, are the Lessor's losses associated with the cancellation borne by the lessee?	Yes - finance lease	No - operating lease
Do any gains or losses from fluctuations in the fair value of the residual fall to the lessee (e.g. in the form of a rebate equalling most of the sales proceeds at the end of the lease)?	Yes - finance lease	No - operating lease
Does the lessee have the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent?	Yes - finance lease	No - operating lease
Are you responsible for maintaining and insuring the asset?	Yes - finance lease	No - operating lease

### Steps to take for equipment leases

If you are introduced to lease agreements by equipment suppliers, it is recommended you take the following steps:

1. Make it clear within your own organisation who is authorised to sign such agreements.
2. Ensure that the supplier of any equipment is reputable and an accredited supplier of the equipment involved.
3. Check the name of the leasing company, and where relevant its parent company, on the page of the lease agreement which you sign and whether this company is a member of the Finance & Leasing Association. FLA members are required to ensure that their contracts are clear and unambiguous.
4. Ensure with the supplier that the equipment is new, or if not that you are content that used or refurbished equipment is suitable.
5. Always ensure that the completed contract corresponds with any verbal or written quotation and, for photocopiers or multi-function devices, a lease proposal sheet supplied via the sales person or negotiator involved.
6. Make sure you understand and agree with all terms and conditions of the contract and, if you are unsure, seek advice.
7. Make sure you understand the costs involved and whether the agreement allows for any automatic increases in charges.



8. Check the period of hire and any notice period required for its termination and the settlement terms to be applied on early termination.

9. Ensure that the length of the agreement is no longer than the expected working life of the equipment involved.

10. Check whether the agreement includes the supply of service(s) and whether this will continue after any minimum or initial period of hire. If you are entering into a separate contract for the provision of service you should check its terms carefully and that the length of the service agreement matches the length of the agreement for the equipment.

11. If any agreements are made to your contract or a further contract is required to replace an existing agreement, do not sign until you have made the same checks as you did for the original agreement.

12. Read your contract carefully before signing it and ensure it is correct, particularly in respect of the rental amount and the period of hire.

### **Photocopiers and Multi-Function Devices**

In addition to the above:

1. Be clear exactly what the copy cost covers.

2. Check if there is any minimum contract period.

3. Check for any minimum monthly charge and ensure you are happy with this, if it applies.

4. The maximum contract period should normally be 5 years.

5. If photocopiers or multi-function devices are bundled with other equipment, it takes the agreement outside the scope and protection of the FLA.

**\*\*NEVER SIGN AN AGREEMENT WHICH IS NOT FULLY COMPLETED.\*\***

### **General Tips**

1. Always, specifically ask for an operating lease

2. Apply proper procurement procedure to obtaining a lease, just as you would for obtaining equipment

3. If the finance document is entitled a Hire or Rental agreement - it may still be a finance lease unless you are paying substantially less than the Recommended Retail Price of the equipment (Discounted with a present value calculation)

4. Never sign an agreement that is not completed in full or that you don't fully understand. If in doubt seek advice.



5. Make sure that the costs are broken down and that you are aware of your obligations for monthly/quarterly payments under the WHOLE value of the contract (what do all the payments over the term add up to? Do you need to consider potential extension rental costs?)
6. Always take a photocopy of any agreement you sign
7. Ensure the term does not exceed the useful life of the asset
8. Confirm what happens at the end of the lease
9. Be aware of any outstanding balances owed on current leased equipment to ensure you are not taking out another lease on replacement equipment and adding the balance outstanding and ultimately paying compounded interest. This is called a "ROLL OVER LEASE" and should BE AVOIDED
10. Do not use leasing (of any type) if you are unable to return the asset. The documentation for an operating lease should include detailed 'Return Conditions' which explain how the equipment should be returned
11. If you are discussing potential amendments to your current contract or a new contract is required to replace an existing agreement - do not sign until you have made all of the same checks as you did for the original agreement.

If you breach the financial regulations that apply it can be very costly. Please seek advice if there are areas of uncertainty.

## **Resources**

Department for Education resources on 'Effective Buying for your School'

<https://www.gov.uk/government/publications/advice-for-effective-buying-for-your-school>