

Finance and Leasing Association
The Department for Education's Guidance on the use of Leases by Schools
December 2011

1. The Department's current Guidance to schools states:

"A Finance Lease is equivalent to you committing the school to a loan, which is prohibited under current legislation." (Academy Procurement Resource: Buying for your Academy)

"An Operating Lease is the only type of lease a school should enter into. These leases involve the school paying a rental fee for the hire of an asset for a period of time, and are similar to a rental agreement. No other types of lease, such as a Finance Lease or hire purchase, may be entered in to by the school as this is a form of borrowing." (Buying Goods and Service section of Department's website)

2. This advice is widely replicated by local authorities. For example:

"Operating leases may be arranged directly by schools with finance companies or the companies providing the equipment. However it is essential that schools check that the above criteria are met within the terms of a prospective lease as failure to do so will result in the agreement being deemed to be a finance lease. Under the legislation finance leases are defined as borrowing. Governors are precluded by law from borrowing and may not therefore enter into any such arrangements." (Devon County Council)

"All LA-maintained schools are expressly forbidden from entering into any form of Finance Lease without approval of the Secretary of State for Education. This constitutes borrowing and is prohibited under section 3.9 of the LA Scheme for Financing Schools (June 2009)." (Leicester Country Council)

"Finance leases are borrowing, which is therefore illegal unless the Secretary of State has given written permission." (Hertfordshire County Council)

3. We set out below the reasons why we believe this advice is inaccurate and increasingly becoming an obstacle to schools' cost-effective management of their equipment needs.

What the law actually says

4. The relevant law includes Schedule 1 of the **Education Act 2002**, which allows schools to borrow only if they have permission of the Secretary of State. But the Act does not itself consider whether Finance Leases are borrowing.
5. The **School Finance (England) Regulations 2011** restrict the use of local authority education budgets. Capital expenditure is only permitted if it is expected to be charged to a revenue account of the authority within the meaning of Section 22 of the Local

Government Act 2003. Again, the Regulations do not themselves set out what should be charged to a revenue account.

6. The **Local Government Act 2003** refers to the need for local authorities to maintain revenue accounts to comply with proper practices, but again does not include a description of how this might apply to leases. Part 1 of the Act requires local authorities to have regard to the Prudential Code for Capital Finance in Local Authorities (see para 10 below).
7. Statute law does not in fact state whether finance leases constitute borrowing, or should be charged to revenue accounts. Public authorities must therefore refer to the relevant accounting guidance and codes of practice.
8. These include the **Code of Practice on Local Authority Accounting**, which takes the form of a Statement of Recommended Practice (SORP) approved by the Accounting Standards Board. It is widely regarded as describing “proper practice” for the purposes of local government legislation. But again, the Code does not itself set out rules governing the charging of leases. Instead, it refers to UK Generally Accepted Accounting Practice (GAAP).
9. The current UK GAAP for leasing (used by local authorities) is the **International Accounting Standard (IAS) for leases, IAS 17**. IAS 17 describes differences between Operating and Finance Leases, but again does not state that Finance Leases should be treated as borrowing by public authorities.
10. It thus falls to the **Prudential Code for Capital Finance in Local Authorities** to set out whether Finance Leases should be regarded as borrowing. Paragraph 67 of the Code (2011 Edition) states that an Authority’s capital financing includes other long-term liabilities including *“finance leases, deferred purchases and similar arrangements in respect of long-term credit”*. This is further clarified in the definitions at paragraph 73, which include the statement: *“Other long term liabilities’ in this Code relate to the liabilities which are outstanding under credit arrangements (as defined by statute for authorities in England, Wales and Northern Ireland).”*
11. In summary, the law itself does not directly set out any restrictions on the use of Finance Leases. The key document is the Prudential Code, which states that Finance Leases are capital financing, and hence borrowing, *if they are credit arrangements*. The rest of this paper considers that question.

Most, if not all, Finance Leases are in fact Hire, not Credit, arrangements

12. By law, any financial arrangement that a school enters into when investing in new equipment may be either a Credit or a Hire arrangement. A Credit arrangement is defined as borrowing, a Hire arrangement not. They are clearly distinguished in law. Customers of Consumer Credit and Consumer Hire have different legal protections – for

example, s56 and s75 of the Consumer Credit Act apply to Credit and not to Hire agreements.

13. Section 15 of the **Consumer Credit Act 1974 (CCA)** defines hire as "*An agreement made by a person with an individual for the bailment or (in Scotland) the hiring of goods to the hirer, being an agreement which (a) is not a hire purchase agreement and (b) is capable of subsisting for more than three months*". Commenting on this section of the Act, Goode's Commercial Law (4th Edition) – the leading commentary on credit law – observes that "*Although hiring may often perform a similar function to credit, and the spread of instalments may be very hard to distinguish from those in an instalment sale, there is no deferment of a debt; the hirer is paying for distinct periods of possession, and in strict theory that is a cash payment for each such period. Indeed, it is precisely for that reason that the draftsman felt it necessary to provide that Hire Purchase is to be treated as credit*".
14. The relevance to the subject of this paper is that both Operating and Finance Leases are in fact Hire agreements. A school entering into a Finance or Operating Lease for equipment is not borrowing money that needs to be repaid. It is hiring equipment in return for a monthly rental.
15. This is illustrated by a recent example from another part of Government. The Energy Act 2008 defines the 'owner' of equipment as "*the person in possession of the plant under a hire purchase agreement, a conditional sale agreement or any agreement of a similar nature*." In establishing the Renewable Heat Incentive this year, Government lawyers determined that "any agreement of a similar nature" would include leasing agreements *only* if they contained a purchase option. It follows that where there is no purchase option for the plant, the lease is a Hire not a Credit arrangement.
16. By law, therefore, most, if not all, leases should be seen as Hire agreements. This means that such leases are not covered by the Education Act requirement to seek the Secretary of State's approval for borrowing, contrary to the Department's current advice to schools.
17. For completeness, it is worth observing that UK GAAP's definition of some Hire agreements as on-balance sheet Finance Leases does not change the legal position.

Why the Department's Guidance matters

18. The Department's current Guidance is having a number of detrimental effects on schools. First, they may be put off, or prevented from, properly assessing all their options for equipment investment. They may only consider Operating Leases, or may simply conclude that all leases are too complicated. This matters, because Finance Leases are often more cost-effective than Operating Leases, simply because they typically involve replacing the equipment less often. Some schools may, as a result, end

up paying more for their equipment than they need to. Others may be unable to invest in the new equipment they need, with a detrimental effect on school performance.

19. These problems are particularly acute for Academy schools, as we understand the Department is applying its current interpretation of the Education Act without any flexibility for these schools, while practice among local authorities varies.
20. We are also aware that some equipment suppliers and other parties may be taking advantage of the situation, claiming that they have the only 'compliant' or 'approved' arrangements. Again, these are very unlikely to be the most cost-effective options for schools.
21. The cost of leases to schools is probably already higher than it needs to be, and is very likely to increase, due to the increased costs faced by finance companies as a result of the problems outlined in this paper. Finance companies often now need to obtain confirmation from local authorities that the Secretary of State's approval has been given. And they also have to deal with claims by some schools that their lease agreements are invalid because they had not obtained the Secretary of State's approval.
22. In addition to the costs associated with these problems for the leasing industry and schools, the Department and local authorities are expending unnecessary effort on 'policing' the use of Finance Leases by schools. We think the associated costs are likely to be over £1.5 million per year.
23. For all these reasons, we hope the Department will agree to conduct an urgent review of existing guidance in this area.

**Finance and Leasing Association
December 2011**