Technical factsheet

Lease accounting under FRS 102

Contents

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Introduction

On 27 March 2024, the Financial Reporting Council (FRC) issued its final amendments to UK and Ireland accounting standards arising from the periodic review. The amendments primarily affect FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, but there are consequential amendments to other standards in the suite of UK and Ireland GAAP.

The FRC estimates that some 3.4 million businesses will be affected by the changes, which are designed to enhance the quality of financial reporting in the UK and Republic of Ireland.

This technical factsheet examines the new lease accounting treatments in FRS 102 (September 2024). The new requirements become mandatory for accounting periods commencing on or after 1 January 2026. Early adoption is permissible, provided that all the periodic review amendments are applied at the same time.

ACCA comment

The September 2024 editions of UK and Ireland accounting standards contain amendments arising from the periodic review, which are not mandatorily effective until accounting periods commencing on or after 1 January 2026. Where an entity has not chosen to early adopt the periodic review amendments, the provisions in the November 2022 editions of UK and Ireland GAAP will continue to apply.

In addition, FRS 102 (September 2024) contains specific disclosure requirements in the statement of cashflows in respect of supplier finance arrangements. These additional disclosure requirements are not mandatorily effective until accounting periods commencing on or after 1 January 2025, although early adoption is also permissible.

It should be noted that micro-entities preparing financial statements under FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime* are unaffected by the new lease accounting requirements.

It is important that entities consider the impact these new requirements have on borrowing facilities, particularly where there may be loan covenants in place. An early-impact assessment is strongly advisable where covenants are in place, as bringing additional assets and liabilities onto the balance sheet under the new lease accounting treatments may mean that debt covenants could be breached. Hence, it is advisable to highlight any such issues to lenders sooner rather than later.

On-balance sheet lease accounting

The FRC has aligned FRS 102, Section 20, *Leases* to IFRS® 16, *Leases*, albeit with some additional simplifications and practical expedients to allow the new treatments to be proportionate to private entities.

Under the new recognition and measurement principles, a lessee does not distinguish between a finance lease and an operating lease. Most leases will be recognised on-balance sheet with two exceptions which relate to:

- leases of assets of low value
- short-term leases.

Leases of low value

FRS 102, para 20.11 provides a list of underlying assets whose value would **not** be considered low value as follows:

- cars, vans, buses, coaches, trams, trucks and lorries
- cranes, excavators, loaders and bulldozers
- telehandlers and forklifts
- tractors, harvesters and related attachments
- boats and ships
- railway rolling stock
- aircraft and aero engines
- land and buildings
- production line equipment.

ACCA comment

It should be noted that this is not a comprehensive list and professional judgement will, of course, be needed to assess what is, and what is not, low value. Effectively, if the leased asset is something similar to the list in paragraph 20.11 above, the asset will not be considered to be low value.

Examples of assets which would be considered low value would be:

- **Laptop computers**
- **Desktop computers**
- **Tablets**
- **Small items of office furniture**

Mobile telephone (on, perhaps, a two-year contract)

The FRC has taken a more permissive approach to defining low-value assets. The term 'low value' is not specifically defined in FRS 102 (September 2024), but paragraph 20.9 clarifies that the assessment of the value of an underlying asset is performed on an absolute basis. Leases of low-value assets qualify for off-balance sheet recognition regardless of whether those leases are material to the lessee (hence materiality issues are irrelevant in determining whether or not a leased asset is low value). In addition, paragraph 20.9 clarifies that the value of lease payments has no bearing on the assessment of whether an underlying asset is of low value.

FRS 102, para 20.10 then states that an underlying asset can be of low value only if:

(a) the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee

(b) the underlying asset is not highly dependent on, or highly interrelated with, other assets.

There is a restriction in paragraph 20.12, whereby if a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

Short-term leases

The FRC has included a new definition of a 'short-term lease' which is:

> *A **lease** that, at the **commencement date** has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.*

Accounting treatment

The new lease accounting requirements will mean more leases will be recognised on-balance sheet. The principal difference is that, for lessees, there will no longer be a requirement to distinguish between an operating lease and a finance lease.

FRS 102, para 1.47 states:

> *A lessee shall not restate comparative information. Instead, it shall recognise the cumulative effect of initially applying the Periodic Review 2024 amendments to Section 20 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.*

Prior-year adjustments must not be carried out on initial application of the new lease accounting provisions. FRS 102, para 1.51(a) states that the lessee shall recognise a lease liability at the date of initial application at the **present value** of the remaining lease payments, discounted using:

(a) the lessee's incremental borrowing rate or

(b) the lessee's obtainable borrowing rate.

The 'lessee's incremental borrowing rate' is defined as:

> *The rate of interest a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.*

The 'lessee's obtainable borrowing rate' is defined as:

> *The rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of **lease payments** to be included in the measurement of the lease liability.*

Example: lease previously treated as an operating lease

Sunnie Ltd signed a five-year lease on 29 December 2024 to lease a bonded warehouse facility and offices. Lease rentals are £137,500 per annum payable on a monthly basis. The lease previously met the operating lease criteria in FRS 102 (January 2022). Sunnie Ltd has an accounting reference date of 31 March. No upfront fees were payable on inception of the lease and no lease incentives were granted. On 1 April 2026, the company could borrow money from a reputable high-street lender at a rate of 7% per annum (see Transition to FRS 102 (2024) later in the example). The lease payments are profiled as follows:

	£	
Lease rentals in the agreement	687,500	
Lease rentals payable per year	137,500	
Lease rentals payable per month	11,458	(rounded)

VAT/equivalent sales taxes have been ignored for the purposes of this example.

<u>In the years to 31 March 2026</u>

The following lease payments have been recognised in profit or loss as the lease was previously accounted for as an operating lease under FRS 102 (January 2022):

	£	
Year to 31 March 2025:	34,375	(£137,500 x 3/12)
Year to 31 March 2026:	137,500	

Lease rentals not paid at each reporting date are as follows:

	£
Year to 31 March 2025	653,125
Year to 31 March 2026	515,625
Year to 31 March 2027	378,125
Year to 31 March 2028	240,625
Period to 31 December 2029	103,125

Transition to FRS 102 (2024)

The date of initial application of the new lease accounting rules is 1 April 2026. On this date, the committed lease rentals (ie unpaid lease rentals) amount to £515,625.

Sunnie Ltd can borrow money at 7% on 1 April 2026, hence on initial application:

Year/period to	Calculation	Present value
	£	£
31.03.2027	137,500 x $1/1.07^1$	128,505
31.03.2028	137,500 x $1/1.07^2$	120,098
31.03.2029	137,500 x $1/1.07^3$	112,241
31.12.2029	103,125 x $1/1.07^3$	84,181
Present value of committed lease payments		**445,025**

The above illustration demonstrates the concepts involved in arriving at the present value of the committed lease payments at the date of initial application of FRS 102 (September 2024); Section 20 and the figures have been annualised for illustrative purposes. In practice, the present value calculations above should be performed on a monthly basis for the most accurate outcome.

Please note, there is no retrospective restatement where a lease was previously classified as an operating lease (FRS 102, para 1.47). Keep in mind that paragraph 1.51(a) states that the lessee recognises a lease liability at the date of initial application at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate or the obtainable borrowing rate.

Sunnie Ltd recognises the right-of-use asset at the amount of the lease liability (as calculated above) adjusted for any prepaid or accrued lease payments (although there are no prepaid or accrued lease payments in this example):

Journal 1

	£
Dr Property, plant and equipment	445,025
Cr Lease liability	445,025

Being recognition of lease at date of initial application

Sunnie Ltd could choose to present this as a right-of-use asset rather than within property, plant and equipment. It could also recognise the asset within property, plant and equipment, and disclose which line items include right-of-use assets.

In the year of initial application of the new accounting treatments, the entity may have already posted the lease rental payments to profit or loss, ie:

Dr Operating lease expense	X
Cr Bank	X

If the lease rentals have been posted to profit or loss during the year of transition to the new lease accounting requirements, a journal to reallocate these will need to be made as follows:

Journal 2	£
Dr Lease liability	137,500
Cr Profit and loss	137,500
Being reallocation of the lease payments	

A further journal will also need to be recorded to include the year-end finance cost (interest) for the lease liability as at 31 March 2027, which will be calculated in the next step (see Journal 4).

Subsequent measurement of right-of-use asset

The right-of-use asset is then depreciated in accordance with FRS 102, Section 17, *Property, Plant and Equipment*. Where there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset is fully depreciated over the shorter of the lease term and its useful economic life.

In addition, the lessee must carry out an assessment at each reporting date as to whether the right-of-use asset is impaired in accordance with FRS 102, Section 27, *Impairment of Assets*.

For the purposes of this example, assuming a four-year useful economic life, the right-of-use asset is depreciated at an amount of £111,256 (£445,025 / 4):

Journal 3	£
Dr Depreciation charges (profit and loss)	111,256
Cr Accumulated depreciation	111,256
Being depreciation of right-of-use asset	

Subsequent measurement of the lease liability

The lease liability is subsequently measured using the amortised cost method in accordance with FRS 102, Section 11, *Basic Financial Instruments*. This uses an effective interest rate and is accounted for as follows:

Year/period	Opening balance	Cashflow	Interest @ 7%	Closing balance
	£	£	£	£
31.03.2027	445,025	(137,500)	28,607	336,132
31.03.2028	336,132	(137,500)	21,607	220,239
31.03.2029	220,239	(137,500)	14,157	96,896
31.12.2029	96,896	(103,125)	6,229	–

The above calculation results in a slightly lower effective interest rate (of 6.43% rather than 7%) as the payments have been apportioned over three years plus the final ending balance of nine months, to ensure that each period has an effective interest charge in profit or loss.

At 31 March 2027, a journal will be required to allocate the finance cost of £28,607 as follows:

<u>Journal 4</u>

	£
Dr Finance cost (profit and loss)	28,607
Cr Lease liability	28,607
Being interest charge on lease liability	

Summary of impact of journals 1 to 4

	Asset	Liability	P&L impact	
Property, plant and equipment	333,769			Journals 1 and 3
Current lease liability		115,893		Journals 1, 2 and 4
Non-current lease liability		220,239		Journals 1, 2 and 4
Impact on profit and loss account			2,363	Journals 2, 3 and 4

Presentation of the lease liability at 31 March 2027

At 31 March 2027, the lease liability is split between the portion falling due within one year of £115,893 (£336,132 – £220,239) and the portion falling due after more than one year of £220,239, to comply with the statutory formats of the balance sheet.

Impact on the financial statements

The overall impact on the financial statements of moving the lease on-balance sheet is as follows:

<u>Impact on profit and loss FRS 102 (2024)</u>

- Depreciation charge £111,256
- Finance cost £28,607
- Total impact £139,863

<u>Impact on profit and loss FRS 102 (2022)</u>

- Lease rental expense £137,500

Overall impact is a reduction in profit of £2,363

<u>Impact on balance sheet FRS 102 (2024)</u>

- Reduction in cash (£137,500)
- Right-of-use asset £333,769
- Lease liability (£336,132)

<u>Impact on balance sheet FRS 102 (2022)</u>

- Reduction in cash (£137,500)

Additional asset is recognised of £333,769 with a current lease liability of £115,893 and a non-current lease liability of £220,239.

If there are issues such as lease incentives (eg a rent-free period) then the calculations above may become a little more complex. For clarity, under FRS 102, lease incentives are amortised over the period of the lease**.**

In the year of initial application, there will be additional work involved in bringing operating leases on-balance sheet. However, once this has been completed, the subsequent accounting treatments should generally be straightforward.

Determining the lease term

FRS 102 defines 'lease term' as:

*'The **aggregate** of:*

*(a) the **non-cancellable period** of a lease;*

*(b) periods covered by an **option to extend** the lease if the lessee is reasonably certain to exercise that option; and*

*(c) periods covered by an **option to terminate** the lease if the lessee is reasonably certain **not** to exercise that option.'*

ACCA comment

The definition above contains the phrase 'reasonably certain' and in our view is a high hurdle to pass. In practice, this will require consideration of all the facts and circumstances that create an incentive for a lessee to extend the lease, where such an option exists; or not to terminate a lease, where such a termination option exists. This is likely to be a challenge in practice, given the subjectivity involved.

FRS 102, para 20.41 outlines factors that should be considered in the assessment of whether, or not, an option in a lease is reasonably certain to be exercised. These factors include:

The contractual terms and conditions compared with market rates	Considering whether the contractual terms of the lease for the optional periods compare favourably with market rates – for example, the amount of any variable lease payments for the lease or other contingent payments.
Significant leasehold improvements	Whether significant leasehold improvements undertaken/expected to be undertaken will have significant economic benefit when the option becomes exercisable.
Termination of the lease	Costs relating to the termination of the lease, such as relocation costs, costs of identifying

	another suitable asset or termination penalties and similar costs that are associated with returning the underlying asset in a contractually specified condition or location.
Importance of the underlying asset	This relates to the importance of the underlying asset to the lessee's operations – for example, its location, whether the asset is specialised in nature and whether suitable alternatives may be available to the lessee. If an entity has a specialist asset, this could indicate a significant economic incentive to exercise a purchase or renewal option if a suitable alternative is not readily available.
Conditions for exercising the option	Whether certain conditions must be met prior to the option being exercised, together with an assessment of the likelihood that those conditions will exist.

Example: early termination option held by the lessor

Bella Enterprises Ltd ('the lessee') enters into a contract to lease a warehouse from Wrigley Properties Ltd ('the lessor') for ten years. The lessor has the option to terminate the lease after six years.

The fact that the lessor can terminate the lease after six years is ignored when calculating the lease term. This is because the lessee has an unconditional obligation to pay for the right-of-use asset (the warehouse) for the period of the lease, unless and until the lessor decides to terminate the lease. Hence, the lessee is contractually obliged to make payments for ten years unless the option to terminate the lease early is exercised by the lessor. Notwithstanding this early termination option, the lessor can still enforce the contract for the full ten-year period.

The lease term is, therefore, ten years.

Cancellable and renewable leases

FRS 102, para 20.39 states:

'In assessing the length of the non-cancellable period of a lease, an entity shall determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.'

The term 'contract' is defined in FRS 102 as:

'An agreement between two or more parties that creates enforceable rights and obligations.'

Where the lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee when the lessee is determining the lease term. Conversely, where only the lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

A **cancellable lease** is one that does not include a specific contractual period but continues indefinitely until either party to the contract gives notice to terminate. This can often arise in related-party arrangements whereby an entity rents premises from a related party (eg a director) but there is no formal contract in place stipulating a lease term.

Conversely, a **renewable lease** is one that includes a specific initial period and renews indefinitely at the end of the initial period until either party to the contract provides notice to terminate.

Example: renewal option included in a lease contract

Bauer Industries Ltd enters into a contract to lease an office space from Olive Property Co Ltd. The contract has an initial non-cancellable period of two years, with an extension for an additional one year if both parties agree. There is no significant penalty for either party if they do not agree to extend for the additional third year.

The initial two-year non-cancellable period meets the definition of a contract because it creates enforceable rights and obligations. The one-year extension period does not meet the definition of a contract because both parties to the lease can individually elect to **not** extend the arrangement without any more than an insignificant penalty. Therefore, at the commencement of the lease, neither party has enforceable rights and obligations beyond the initial non-cancellable period.

As you can see, both a cancellable lease and a renewable lease continue for an indefinite period of time after the initial non-cancellable period until either party to the contract decides to terminate the contract.

If a lessee concludes that the contract is enforceable beyond the notice period of a cancellable lease, it must then apply FRS 102, para 20.38 to assess whether the lessee is reasonably certain not to exercise a termination option.

Month-to-month or 'evergreen' leases

Month-to-month or 'evergreen leases' are also known as 'rolling', 'perpetual' or 'holdover' leases. The nature of the leases is such that there is no fixed lease term and the contract simply continues until one party to the contract provides notice to terminate it. The notice period may be relatively short (eg one month).

Such leases exist usually between related parties (eg where a subsidiary may rent premises from its parent or where a company may rent premises from a director-shareholder) and these arrangements usually have no written agreement in place. Such arrangements usually involve below-market-rate rentals (also known as 'peppercorn' rentals) being paid to the lessor or, in some cases, no rent payments at all.

Where such arrangements are in place, both parties usually expect the arrangements to continue for a significant period of time – particularly as the lessee would have a significant economic incentive to continue the arrangement because it is unlikely the lessee could rent premises under a similar arrangement for below-market rates of rent.

Where such arrangements exist, it is up to the lessee to determine the appropriate lease term. Generally, this is likely to be for a long period of time and hence the lease term could be based on the estimated useful life of the building – for example, 50 years.

ACCA comment

FRS 102, para 20.5 provides an exemption from on-balance-sheet recognition for leases that are **short-term**. 'Short-term leases' are defined as:

*'A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.'*

Potentially, short-term leases include evergreen leases which are those on a day-to-day, week-to-week or month-to-month basis.

Lessor accounting

There have been no changes to the way in which lessors initially recognise and measure leases. A lessor will continue with existing accounting treatments.

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