

Leasing (Lecture A851 – 15.52 minutes)

FRS 102 deals with leasing in Section 20 *Leases*. The current accounting treatments are planned for significant change once the FRC has completed its periodic review of UK and Ireland GAAP. It is expected the FRC will issue the final amendments to FRS 102 in respect of leasing during the first half of 2024. It should be emphasised that there are no planned changes to lease accounting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

The remainder of this section will examine the accounting treatments under the current regime in FRS 102 (January 2022).

Lease term

To understand many of the requirements of FRS 102 (and FRS 105), it is necessary to understand what is meant by the phrase 'lease term' which is used throughout the relevant sections. The Glossary to FRS 102 defines 'lease term' as follows:

*The non-cancellable period for which the lessee has contracted to **lease** the **asset** together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the **inception of the lease** it is reasonably certain that the lessee will exercise the option.*

FRS 102
Glossary **lease term**

A certain amount of judgement will be required to determine the lease term for the purpose of FRS 102. For example, if a lease has an initial term of five years, but there is an option to continue for a further five years, it must be established whether the lease term is five or ten years. The definition states that if it is 'reasonably certain' that the lessee will exercise the option, then the lease term will be determined to be ten years.

In practice, a number of factors will need to be considered – some of which will be easier to judge than others. For example, if the rent in the secondary period is just a peppercorn rent, or otherwise much lower than in the primary term, it may be easy to conclude that the option to extend the lease will be taken. However, if the secondary period will have a market rate rental, then consideration will be needed as to the likelihood of the option to extend being taken. Information, such as whether the business's plans and budgets assume they are staying in the leased premises for ten years, or using the leased assets for ten years, will help in forming a judgement. Additionally (especially for leasehold premises), if fixtures and fittings or other improvements have been made, with a life suggesting that the intention is to stay for ten years, this would indicate that it is potentially reasonably certain that the option to extend the lease will be taken.

Overall, all of the factors indicating whether, or not, the lease term will be extended (or curtailed if it is an option to cancel the lease) need to be considered by management and a conclusion on the lease term reached. It is a good idea to document the reasoning and any evidence that management have used, especially if the entity is audited, as the auditor will require such information.

Lease classification

UK and Ireland GAAP states that a lease is classified as a finance lease if the lease transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

A 'finance lease' is defined in the Glossary to FRS 102 as:

*A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **asset**. Title may or may not eventually be transferred. A lease that is not a finance lease is an **operating lease**.*

FRS 102
Glossary
finance lease

An 'operating lease' is defined as:

*A **lease** that does not transfer substantially all the risks and rewards incidental to ownership. A lease that is not an operating lease is a **finance lease**.*

Correct classification of a lease as a finance or operating lease is crucial. In practice, some entities would prefer to have an operating lease as the lease is then not reported on the balance sheet which improves gearing ratios and the overall financial position on the balance sheet. This is one of the 'stinging points' surrounding the proposals by the FRC to overhaul lease accounting for lessees so that the vast majority of leases are reported on-balance sheet.

FRS 102 requires the classification of a lease between finance and operating to be done on the basis of the substance of the arrangement and not its legal form. Essentially, a lease is treated as a finance lease when the **risks and rewards** incidental to ownership pass from the lessor to the lessee. If substantially all the risks and rewards incidental to ownership do not pass from the lessor to the lessee, the lease is an operating lease. Some of the more common examples of risks and rewards are shown below:

Risks	Rewards
<ul style="list-style-type: none">• Losses incurred due to idle capacity of the leased asset.• The leased asset becomes technically obsolete due to enhancement or changes in technology.• Economic conditions give rise to a reduced level of economic benefits.	<ul style="list-style-type: none">• The entity expects to benefit from increases in the value of the leased asset.• The entity will benefit from profitable operations over the useful life of the leased asset.

FRS 102 and FRS 105 both provide eight indicators that a lease falls to be classified as a finance lease as follows:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

When legal title transfers to the lessee at the expiration of the lease, the lessee will essentially legally own the asset and hence the risks and rewards of ownership will continue. It should be noted that on inception, and during, the lease, the lessee does not legally own the leased asset; but in substance has acquired an asset which has been financed through a leasing arrangement. This is the reason why the asset subject to the finance lease is recognised on the balance sheet with a corresponding liability in respect of the lease obligations.

(b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

An option to purchase the asset at a price that is sufficiently lower than fair value is essentially a call option (the lessor has a corresponding put option for the same value of the leased asset).

In a finance lease, the lessee has the option to purchase the asset at a price less than fair value of the asset and so it will almost certainly exercise that right. This means it will hold the asset for its entire useful life and hence indicates that the lease is a finance lease.

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred.

In this instance, it is presumed that the lessee will consume the economic benefits within the asset over the major part of the useful economic life to such an extent that the residual value at the end of the lease term is so low that the lessor would derive no significant benefit from either selling the leased asset or leasing it to another party once the lease has expired. Accounting standards do not provide guidance on what constitutes the 'major part', nor do they provide benchmarks and hence this criterion will involve professional judgement.

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

This criterion tests whether the lessor receives a full return on the initial investment in the asset. Professional judgement will be needed to determine whether the present value of the minimum lease payments equates to at least substantially all of the fair value of the leased asset. The substance of the lease must also be considered and whether substantially the risks and rewards of ownership are passed from lessor to lessee.

(e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Some assets may have been specifically constructed for the lessee and third parties would only be able to use them if major modifications are made. In these situations, the market value of specialised assets is limited and hence the lessor will attempt to recover its investment in the asset through the finance lease.

There are three additional indicators of situations that individually, or in combination, could also lead to a lease being classified as a finance lease as follows:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

Evidence that the lessee will suffer a financial penalty by cancelling the lease before its expiry date is an indicator that, at the inception of the lease, both parties do not intend for cancellation to occur.

(b) Gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).

Even if legal title of the asset does not pass to the lessee at the end of the lease, the lessee may bear the risks and rewards of fluctuations in the asset's fair value. Additional analysis will be required where gains and losses from the fluctuation in the residual value are shared between the lessee and the lessor to establish whether, or not, the lessor retains a significant share. If evidence suggests that the lessor retains a significant share in the residual value, but only in circumstances which are considered to be remote, classification as a finance lease will still be appropriate.

(c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The rent for the secondary period would be significantly lower than what would otherwise be charged. This criterion suggests that the lessor has received their required return and that the lessee is likely to continue the lease into the secondary period.

Finance leases: lessees

On initial recognition of a finance lease, FRS 102, para 20.9 states that the lessee must recognise its rights and obligations under a finance lease as an asset and a liability in the balance sheet at an amount equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the inception of the lease.

Any directly attributable costs in negotiating and arranging the lease are added to the amount recognised as an asset.

In a finance lease, the lessee has effectively acquired an asset which has been financed through a leasing arrangement. The amount capitalised as an asset represents the lessee's right to use the asset and the liability represents the lessee's obligations to pay rentals to the lessor over the life of the lease. Where there are no directly attributable costs involved in negotiating and arranging the lease, and no initial deposit, the two amounts will be equal at initial recognition.

Subsequent measurement

After initial recognition of a finance lease at either fair value or the present value of the minimum lease payments, FRS 102, para 20.11 states that the lessee must apportion the minimum lease payments between the finance charge (interest) and the reduction of the outstanding liability (principal) using the effective interest method. The finance charge is allocated to each accounting period during the lease term so as to produce a constant periodic rate of return of interest on the remaining balance of the liability. Contingent rents are charged as an expense in the periods in which they are incurred.

FRS 102 requires the use of the effective interest method which is used in Section 11 *Basic Financial Instruments* and is a method which exactly discounts the estimated future cash payments for a lessee, or future cash receipts for a lessor, over the life of the lease. This can be easily calculated using the Goal Seek function in Microsoft Excel.

In addition to allocating interest over the life of the lease, FRS 102, para 20.12 requires the lessee to depreciate the asset in accordance with Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill*. In situations where there is uncertainty as to whether the lessee will obtain ownership at the end of the lease term, the asset is fully depreciated over the shorter of the lease term and the asset's useful life. In addition, FRS 102, para 20.12 requires the lessee to assess whether the leased asset is showing signs of impairment in accordance with Section 27 *Impairment of Assets*.

Example – Finance lease

Morley Industries Ltd enters into a finance lease for an item of machinery that has a fair value of £35,000 (this is also equivalent to the present value of the minimum lease payments).

The term of the lease is for five years, which is also considered to be the major part of the

economic life of the machine and hence the lease qualifies for treatment as a finance lease per FRS 102, para 20.5(c).

The machine is not expected to have any residual value at the end of the five-year lease.

The monthly payments, comprising capital and interest, are £685 per month and there is an option to purchase fee payable at the end of the lease term for £150 which is included in the final payment. The company has not incurred any arrangement fees in connection with this lease.

In years one to four, the company will pay £8,220 (£685 x 12) and in year five it will pay £8,370 (£685 x 12 + £150). The lease provisions are profiled in an Excel spreadsheet as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3	Year	Opening liability	Cash flow	Interest at EIR	Closing liability
4		£	£	£	£
5	1	35,000	(8,220)	0	26,780
6	2	26,780	(8,220)	0	18,560
7	3	18,560	(8,220)	0	10,340
8	4	10,340	(8,220)	0	2,120
9	5	2,120	(8,370)	0	(6,250)

The formulas in the above spreadsheet are as follows:

	A	B	C	D	E
1	Effective interest rate				
2					
3	Year	Opening liability	Cash flow	Interest at EIR	Closing liability
4		£	£	£	£
5	1	35000	-8220	=C1*B5	=B5+C5+D5
6	2	=E5	-8220	=C1*B6	=B6+C6+D6
7	3	=E6	-8220	=C1*B7	=B7+C7+D7
8	4	=E7	-8220	=C1*B8	=B8+C8+D8
9	5	=E8	-8370	=C1*B9	=B9+C9+D9

The Goal Seek function in Excel can be used to work out the effective interest rate in cell C1 that can then be applied to cells D5 to D9 resulting in cell E9 becomes £nil.

To use the Goal Seek function go to the Data tab at the top of the Excel worksheet and then select 'What-if Analysis'.

The objective is to get cell E9 to show a value of £nil by changing C1 so as to work out the effective interest over the life of the lease.

Once the Goal Seek function is selected, the following information is entered:

Goal Seek

Set cell:

To value:

By changing cell:

Click 'OK' and Excel will calculate the effective interest rate in cell C1 and the interest expense in cells D5 to D9 automatically as follows:

	A	B	C	D	E
1	Effective interest rate		5.72%		
2					
3	Year	Opening liability	Cash flow	Interest at EIR	Closing liability
4		£	£	£	£
5	1	35,000	(8,220)	2,004	28,784
6	2	28,784	(8,220)	1,648	22,211
7	3	22,211	(8,220)	1,272	15,263
8	4	15,263	(8,220)	874	7,917
9	5	7,917	(8,370)	453	(0)

The effective interest rate has been calculated at 5.72% and is allocated to each period during the term of the lease in order to produce a constant periodic rate of interest on the remaining liability. You will note that interest charges are higher in the earlier years of the lease and lower in the later years.

The depreciation charges on this machine are charged over the life of the lease at an amount of £7,000 as there is no residual value left at the end of the useful life of five years.

The journals in year 1 are as follows:

	£
Dr Plant and machinery additions	35,000
Cr Finance lease obligation	35,000

Initial recognition of machine on lease

Dr Depreciation expense	7,000
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Cr Accumulated depreciation	7,000
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Being year 1 depreciation charge

Dr Finance lease obligation	8,220
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Cr Cash at bank	8,220
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Being payments to lessor in year 1

Dr Interest expense	2,004
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Cr Finance lease obligation	2,004
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Being interest on finance lease at EIR

At the end of year 1, the finance lease obligation of £28,784 is split between the amount falling due within one year of £6,573 (£28,784 - £22,211) and the amount falling due after more than one year of £22,211 to comply with the statutory formats of the balance sheet.

While the effective interest rate is inherently more complex than, say, the level-spread method, it does produce a more realistic interest expense in profit and loss as it is based on the remaining liability.

Operating leases: lessees

When a lessee enters into an operating lease, the risks and rewards incidental to ownership of the asset remain with the lessor and so the leased asset is not recognised on the lessee's balance sheet; nor is a corresponding lease liability. The lease payments are simply recognised in profit or loss on a straight-line basis as an expense over the life of the lease to comply with FRS 102, para 20.15.

FRS 102, para 20.15 recognises two exceptions to the straight-line recognition method and an alternative basis can be used by an entity if:

- (a) *another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or*
- (b) *the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition (b) is not met.*

FRS 102, para 20.15

The following example is reproduced from FRS 102, para 20.15.

Example of applying FRS 102, para 20.15(b)

X operates in a jurisdiction in which the consensus forecast by local banks is that the general price level index, as published by the government, will increase by an average of 10% annually over the next five years. X leases some office space from Y for five years under an operating lease. The lease payments are structured to reflect the expected 10% annual general inflation over the five-year term of the lease as follows:

Year 1	CU100,000
Year 2	CU110,000
Year 3	CU121,000
Year 4	CU133,000
Year 5	CU146,000

X recognises annual rent expense equal to the amounts owed to the lessor as shown above. If the escalating payments are not clearly structured to compensate the lessor for expected inflationary cost increases based on published indexes or statistics, then X recognises annual rent expense on a straight-line basis: CU122,000 each year (sum of the amounts payable under the lease divided by five years).

Lease incentives

FRS 102, para 20.15A states that a lessee is to recognise the aggregate benefit of lease incentives as a reduction to the operating lease expense over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset. Any costs which are incurred by the lessee (such as costs for termination of a pre-existing lease, relocation or leasehold improvements) are to be accounted for in accordance with the relevant section of FRS 102 or FRS 105.

The term 'lease incentives' is defined as follows:

*Incentives provided by the lessor to the lessee to enter into a new or renew an **operating lease**. Examples of such incentives include up-front cash payments to the lessee, the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with pre-existing lease commitments of the lessee), or initial periods of the **lease** provided by the lessor rent-free or at a reduced rent.*

FRS 102
Glossary **lease incentives**

Example – Accounting for a lease incentive

Dwyer Ltd enters into an operating lease with Walker Ltd to rent a commercial building for ten years. No rent is payable in the first two years and thereafter the rent is payable at £15,000 per annum.

The rent-free period of one year should be allocated over the entire lease term by spreading the total lease rental for the lease term using the straight-line basis.

The total rental expense for the ten-year lease term is 8 years x £15,000 = £120,000. The expense for each period, including years 1 and 2 will be £120,000 / 10 = £12,000.

At the end of years 1 and 2, the balance sheet will show accrued rent payable of

£12,000 and £24,000 respectively. This is reduced by £3,000 over the remaining eight years.

Finance leases: lessors

Initial recognition

FRS 102, para 20.17 requires a lessor to recognise assets held under a finance lease in the balance sheet and to present them as a receivable (i.e. a debtor) at an amount equal to the net investment in the lease. The net investment in the lease is the lessor's gross investment in the lease discounted at the interest rate implicit in the lease. FRS 102, para 20.17 then goes on to clarify that the gross investment in the lease is the total of:

- (a) the minimum lease payments receivable by the lessor under a finance lease;
- (b) any unguaranteed residual value accruing to the lessor.

Therefore, when a lessor enters into a finance lease with a lessee, the lessor must derecognise the asset and then recognise a new asset, which is the net investment in the lease. Differences between the two values will be recorded as a profit or loss on disposal (unless the lessor is a manufacturer or dealer).

The net investment in the lease is the equivalent of the present value of the future rentals receivable plus the residual asset that goes back to the lessor at the end of the lease. The difference between the **gross** investment in the lease and the **net** investment in the lease is unearned finance income.

Where the lessor incurs any directly attributable costs (i.e. costs which are incremental in negotiating and arranging the lease such as legal fees), these are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the term of the lease. General overheads (such as marketing costs) are not included.

Subsequent measurement

FRS 102, para 20.19 states that the recognition of finance income is to be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease. Lease payments which relate to the accounting period (excluding costs in respect of services) are applied against the gross investment in the lease to reduce both the capital amount and the unearned finance income (interest). FRS 102, para 20.19 then goes on to state that if there is an indication that the estimated unguaranteed residual value using in calculating the lessor's gross investment in the lease has changed significantly, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately in the profit and loss account.

Contingent rents are excluded from the minimum lease payments and hence from the net investment included in the balance sheet. As a result, where contingent rents arise, the lessor should include them as an additional finance income of the period in which they arise. In addition, where the lessor grants any lease incentives to the lessee, the calculation of the minimum lease payments and the determination of the interest rate implicit in the lease will include nil payments by the lessee during such rent-free periods.

Manufacturer or dealer lessors

Manufacturer or dealer lessors are dealt with in FRS 102, paras 20.20 to 20.22. Paragraph 20.20 states that a finance lease of an asset by a manufacturer or dealer lessors will give rise to two types of income:

- (a) profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;
- (b) finance income over the lease term.

FRS 102, para 20.21 then goes on to state that the sales revenue which the manufacturer or dealer lessor recognises at the commencement of the lease term is the fair value of the asset or, if lower, the present value of the minimum lease payments accruing to the lessor which are calculated using a market rate of interest. Cost of sales in the manufacturer or dealer lessor's books is the cost, or carrying amount where different, of the lease asset less the present value of the unguaranteed residual value. The difference between the sales value and the cost of sale is the selling profit which is recognised in accordance with the entity's policy for outright sales.

FRS 102, para 20.22 states that where artificially low rates of interest are quoted, selling profit must be restricted to that which would apply if a market rate of interest were charged. Costs that are incurred by a manufacturer or dealer lessor in connection with negotiating and arranging a lease are to be recognised as an expense when the selling profit is recognised.

Operating leases: lessors

FRS 102, para 20.24 requires a lessor to present assets subject to operating leases in its balance sheet depending on the nature of the asset.

Generally, such assets will be presented in the balance sheet as property, plant and equipment in accordance with Section 17 *Property, Plant and Equipment*. However, where an entity routinely sells assets which they have held for rental to others (e.g. car hire companies), they can transfer those assets to stock at their carrying amount when they cease to be rented and become held for sale.

Revenue

FRS 102, para 20.25 requires a lessor to recognise lease income from operating leases (excluding amounts in respect of services such as insurance and maintenance) in profit or loss on a straight-line basis. Similar principles exist in FRS 105, para 15.24. Unlike FRS 105, FRS 102 recognises two exceptions to the straight-line method of income recognition which are where:

- (a) *another systematic basis is representative of the time pattern of the lessee's benefit from the leased asset, even if the receipt of payments is not on that basis;* FRS 102, para 20.25 (a) and (b)
or
- (b) *the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then condition (b) is not met.*

In practice, most rental income will be recognised on straight-line basis. However, differences may arise where rental receipts are either not constant throughout the term of the lease or accounting periods are not coterminous. In such cases, the lessor will recognise the amount of income

receivable in the current accounting period, which may result in accrued or deferred income balances being recognised.

Lease incentives

Lease incentives for lessors are dealt with in FRS 102, para 20.25A and FRS 105, para 15.25. Both of these paragraphs require the aggregate cost of lease incentives to be recognised over the lease term on a straight-line basis, unless another systematic basis is representative of the time pattern over which the lessor's benefit from the leased asset is diminished.

Lease incentives should not be recognised immediately in the lessor's profit and loss account because this would not be consistent with the lease term (unless, of course, the lease term was shorter than the accounting period itself).

Expenses

FRS 102, para 20.26 and FRS 105, para 16.26 require a lessor to recognise as expenses, costs including depreciation which are incurred in earning lease income. The lessor's depreciation policy for depreciable leased assets must be consistent with the lessor's normal depreciation policy for similar assets.

To apply the provisions in paragraphs 20.26/15.26 of FRS 102/FRS 105, the principles in Section 17 *Property, Plant and Equipment* and Section 18 *Intangible Assets other than Goodwill* (FRS 102) and Section 12 *Property, Plant and Equipment and Investment Property* (FRS 105) and Section 13 *Intangible Assets other than Goodwill* will apply.

Initial direct costs

Lessors are required to add to the carrying amount of a leased asset any initial direct costs which it incurs in negotiating and arranging an operating lease and must recognise these costs as an expense over the term of the lease on the same basis as lease income.

In practice, such costs will usually involve legal fees in drawing up the lease. Such costs will be added to the carrying amount of the leased asset as they are directly attributable in negotiating and arranging the lease and will be recognised within the depreciation charge in profit or loss in the relevant accounting period. General overhead costs, e.g. marketing fees, are not to be included and must be expensed to the profit and loss account in the period in which they are incurred.

Impairment

The impairment provisions of FRS 102, Section 27 *Impairment of Assets* and FRS 105, Section 22 *Impairment of Assets* apply equally to leased assets. At each reporting date, the lessor must assess whether the leased asset is showing indicators of impairment and where the leased asset's recoverable amount is lower than carrying amount, an impairment loss is to be recognised in profit or loss.

Manufacturer and dealer lessors

Manufacturer and dealer lessors recognise no selling profit on entering into an operating lease because it is not the equivalent of a sale.