

Lease accounting (Lecture A859 – 15.44 minutes)

One of the most significant changes brought about by the FRC's periodic review is in respect of lease accounting (for lessees).

At the outset, it is worth emphasising that the lease accounting requirements have only changed in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. There have been no changes made to the lease accounting provisions in FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Hence, micro-entities preparing accounts under FRS 105 will continue to account for leases on a risks and rewards basis and will continue to distinguish between a finance and an operating lease.

Current requirements

FRS 102 (January 2022) works on a 'risks and rewards' approach. If the risks and rewards incidental to ownership of the leased asset remain with the lessor, the lease is, in substance, an operating lease and hence is not recognised on the balance sheet. Lease rentals are recognised in profit or loss on a straight-line basis over the lease term (or on another systematic basis if this is appropriate).

Where the risks and rewards incidental to ownership of the leased asset pass from the lessor to the lessee, the lease is, in substance, a finance lease. In other words, the entity has acquired an asset for use in its business that has been financed by way of a leasing transaction. Finance leases are recognised on-balance sheet with a corresponding finance lease payable. There is then interaction with other areas of FRS 102:



Initial recognition of the lease is dealt with in FRS 102, Section 20. The asset subject to the finance lease is then measured in accordance with Section 17 (or Section 18 *Intangible Assets other than Goodwill* if an intangible asset) for initial cost recognition and subsequent depreciation, and Section 27 *Impairment of Assets* for consideration of impairment. The finance lease obligation is measured under Section 11 using the amortised cost method which uses an effective interest rate.

Correct classification of a lease as either finance or operating is critical because getting this wrong (or deliberately engineering a lease to achieve a desired outcome) will present a misleading picture in the financial statements.

These existing requirements will continue for micro-entities preparing financial statements under FRS 105. In addition, there is no change to the way in which lessors account for their leases (the new accounting treatments affect lessees).

New requirements

The new lease accounting treatments remove the distinction between a finance lease and an operating lease for lessees.

With only a couple of exceptions, lessees will generally be required to bring all leased assets onto the balance sheet.

This means that lessees will have to bring more of their current operating leases onto the balance sheet under the new requirements.

To sum up the new requirements in a very small nutshell, there will be far more finance leases hence capitalisation of leased assets and recognition of finance lease obligations.

Discount rate to be used

The lease payments contained in the lease agreement will be discounted to essentially arrive at the value of the leased asset and corresponding finance lease liability.

In other words, at initial recognition, the entity measures the lease liability at the present value of the lease payments that are not paid at that date.

FRS 102, para 20.49 states that the interest rate to be used in discounting the lease payments will be the interest rate implicit in the lease (where this can be readily determined). The 'interest rate implicit in the lease' is defined as:

*The rate of interest that causes the **present value** of:*

- (a) *the **lease payments**; and*
- (b) *the unguaranteed **residual value** to equal the sum of:*
 - (i) *the **fair value** of the **underlying asset**; and*
 - (ii) *any initial direct costs of the lessor.*

*Amendments to
FRS 102 and
other FRSs
(March 2024)
Glossary:
**interest rate
implicit in the
lease***

If the interest rate implicit in the lease cannot be determined reliably, the entity can choose (on a lease-by-lease basis) to apply either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate. For clarity, these terms are defined as follows:

*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.*

*Amendments to
FRS 102 and
other FRSs
(March 2024)
Glossary:
**lessee's
incremental
borrowing rate***

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.

FRS 102, para 20.51 then goes on to clarify that the lease payments included in the measurement of the lease liability (i.e., those not paid at the commencement date of the lease) comprise the following:

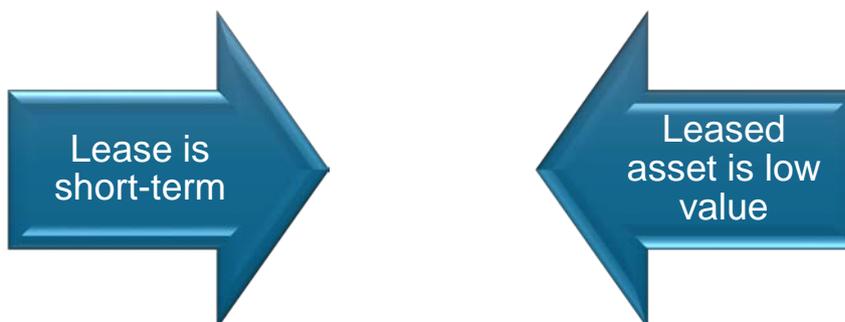
- (a) *fixed payments (including in-substance fixed lease payments as described in paragraph 20.52), less any lease incentives receivable;*
- (b) *variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraphs 20.53 and 20.54);*
- (c) *amounts expected to be payable by the lessee under **residual value guarantees**;*
- (d) *the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs 20.41 to 20.44); and*
- (e) *payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

The key message the FRC is keen to get out there is that this should not be over-complicated. Getting the obtainable borrowing rate, for example, could be as easy as picking up the 'phone to the bank and asking them at what rate could the business borrow money at?

In the Exposure Draft, a 'publicly available rate' (i.e. a gilt rate) was also suggested. It is worth noting that the finalised amendments have removed this option.

Exemptions from on-balance sheet recognition

There are two situations when a lease need not be recognised on-balance sheet:



Short-term lease

A **short-term** lease is a lease which, at the commencement date, has 12 months or less to run. Keep in mind that a lease which contains a purchase option is **not** a short-term lease.

Amendments to
FRS 102 and
other FRSs
(March 2024)
Glossary:
**lessee's
obtainable
borrowing rate**
Amendments to
FRS 102 and
other FRSs
(March 2024),
para 20.51.

Low-value assets

In the Exposure Draft, the FRC chose to provide a list of examples of assets that the standard would consider as being of low value (computers, printers, tablets etc).

In the final amendments, this list has been removed and, instead, the standard provides a list of assets that would **NOT** be 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

*Amendments to
FRS 102 and
other FRSs,
para 20.11*

In developing the revised FRS 102, Section 20, the FRC deliberately did not include monetary amount for low value. In contrast, the Basis for Conclusions in IFRS 16 does indicate an amount of US\$5,000 which the IASB had in mind when they were developing IFRS 16. This number seems to be the number that IFRS reporters have 'clung onto' when dealing with the low value assets issue.

The updated lease accounting treatments are more permissive than IFRS 16 – and that is a key difference and is one of the reasons why the FRC have not included a monetary amount for low value. This means that preparers should ensure that for leases of assets that are not low value, these should be recognised on-balance sheet (for example, if you can climb into the asset, then recognise it on-balance sheet). If the entity has smaller things, the standard is happy to leave the treatment to professional judgement and an entity can go as small as it likes in terms of determining low value. In developing this section of FRS 102, the FRC decided to enable it to be proportionate to reflect the size of the task that entities are being asked to take on.

Guidance on key technical areas such as the low value issue and discount rate is expected to be published, certainly by the professional bodies, and we will examine these issues in further detail next quarter.

Expected impact on financial statements

The lessee capitalises the 'right-of-use' asset with a corresponding lease liability in a similar way as current finance lease accounting works in FRS 102 (January 2022).

Balance sheet

On the balance sheet, the lessee recognises a new asset at the present value of the future lease payments together with any directly attributable costs of obtaining the lease (e.g. legal fees) and a corresponding finance lease liability.

If applying the cost model, the subsequent measurement basis for the asset in Section 20 will apply, but the entity looks to Section 17 for depreciation only and Section 27 for impairment. If applying other measurement models, the entity looks at Section 16 *Investment Property* for investment properties (unless the entity is applying the intra-group exemption); or Section 17 for the revaluation model.

The lease liability is measured using the amortised cost method which uses an effective interest rate. The derecognition requirements of FRS 102, paras 11.36 to 11.38 apply to lease liabilities.

The lease liability is split between current and non-current liabilities to comply with the statutory formats of the balance sheet.

Profit and loss account

The current operating lease rental expense is replaced with depreciation, any applicable impairment and a finance cost (see above) for the unwinding of the lease liability.

Impact on KPIs/key figures

The following KPIs/key figures are likely to be impacted as a result of the new lease accounting treatment, and hence it is important that issues such as existing debt covenants are considered to see the impact on these:

- EBITDA will increase by the value of the operating lease expense that is removed.
- Finance and depreciation charges will be higher (which could affect lending covenants).
- The gross assets (balance sheet total) test may be breached due to additional right-of-use assets being recognised, although the government have announced an intention to increase the company size thresholds – see **Section 7** of these notes.
- Net current assets will be decreased due to the current lease liability.
- Gearing ratios will increase, depending on the definitions of debt.