Financial Reporting Council

Accounting and Reporting Policy
FRS 102

Staff Education Note 6
Leases

Contents

Introduction

This Staff Education Note compares the accounting treatment for leases under current UK accounting standards (including SSAP 21 *Accounting for leases and hire purchase contracts, FRS 5 Reporting the substance of transactions* and UITF abstract 28 *Operating lease incentives*) and Section 20 *Leases* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

While the two frameworks are conceptually similar, there are some application differences that are highlighted in this Staff Education Note:

a) Classification of leases between operating and finance
b) Determination of whether an arrangement contains a lease
c) Accounting for finance leases
d) Accounting for operating leases

This Staff Education Note is written to highlight key areas of consideration when transitioning to FRS 102 and is not designed to be exhaustive.

Classification of leases

Both SSAP 21 and FRS 102 require an entity to classify each of its leases as either a finance lease or an operating lease.

SSAP 21	**FRS 102**
A finance lease is defined as one that transfers substantially all the risks and rewards of ownership of an asset to the lessee. There is a rebuttable presumption that if, at inception, the present value of the minimum lease payments amounts to 90% or more of the fair value of the leased asset, the lease is a finance lease. To rebut the presumption, preparers might look to other indications about risks and rewards, though this rebuttal is expected only to happen in exceptional circumstances. (SSAP 21 paragraphs 15 and 16)	Takes a risks and rewards approach to lease classification and has an almost identical definition for a finance lease. Gives a list of situations which individually or in combination would normally lead to a lease being classified as a finance lease: (a) the lease transfers ownership of the asset to the lessee by the end of the lease term. (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the 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. (c) the lease term is for the major part of the economic life of the asset even if title is not transferred. (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. (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications. (FRS 102 paragraph 20.5) Gives a list of secondary considerations that might also lead to finance lease classification. (FRS 102 paragraph 20.6) However there is no direct equivalent to the 'bright line' 90% test under SSAP 21.

Both standards aim to identify those situations where substantially all the risks and rewards of ownership of an asset are held by a lessee, but use different specific tests or indicators. Therefore, there are unlikely to be many cases where the lease classification will change as a result of applying of FRS 102.

Example 1
Lease classification – Specialised assets

This example is designed to illustrate the different elements of the lease classification decision-making process and may not be representative of a typical lease seen in practice.

Facts

Company A leases a bespoke piece of machinery from Company B. The machinery was constructed for use in Company A's specialist business, to its specification and is used in producing an item for which Company A holds the patent, so a third party would not legally be able to use the machinery without significant alteration. The lease is for a period of seven years and the expected useful life of the machinery is at least 10 years. The present value of the minimum future lease payments is 70% of the asset's fair value at inception.

SSAP 21

The present value of the minimum lease payments is only 70% of the fair value of the asset at the inception of the lease, therefore, it may be classified as an operating lease[1].

FRS 102

Under FRS 102, the lease would pass the condition set out in paragraph 20.5(e) and so would be classified as a finance lease.

[1] SSAP 21 does not rely exclusively on the '90% test'. Paragraph 16 of SSAP 21 notes "the presumption that a lease which fails to meet the conditions in paragraph 15 (ie including the '90% test') is not a finance lease may in exceptional circumstances be rebutted". In practice (outside this stylised example) the economics of this example are questionable and it is likely that Company A would need to consider other factors, which may result in classification as a finance lease. In which case there would be no difference in lease classification arising from application of FRS 102.

Determining whether an arrangement contains a lease

SSAP 21 / FRS 5	FRS 102
SSAP 21 applies only to leases ie to arrangements that meet the definition of 'a contract between a lessor and lessee for the hire of a specific asset'. Other contracts may have some features in common with leases, but are outside the scope of SSAP 21. FRS 5 *Reporting the substance of transactions* Application Note F *Private Finance Initiative and Similar Contracts* may apply to these contracts – it is relevant to contracts for services, where an asset is necessary to perform the contracted services.	Some arrangements do not take the legal form of a lease but convey rights to use assets in return for payments. Examples of arrangements in which one entity (the supplier) may convey a right to use an asset to another entity (the purchaser), often together with related services, may include outsourcing arrangements, telecommunication contracts that provide rights to capacity and take-or-pay contracts. (FRS 102 paragraph 20.3) Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether: (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets. Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. An asset is implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets; and (b) the arrangement conveys a right to use the asset. This will be the case where the arrangement conveys to the purchaser the right to control the use of the underlying asset. (FRS 102 paragraph 20.3A)

Example 2
Arrangement that contains a lease

Facts

Company C enters into a contract to provide electricity to Company D, and for this purpose Company C has to construct a new substation, as Company D is based on a remote island. Realistically, the only way to get the required electricity to Company D is by use of this substation, and no one else does or can benefit from its use.

FRS 5

This arrangement would not be in the scope of SSAP 21 as there is no lease over a specified asset in place; it is a contract to provide a service. The arrangement would be considered by applying FRS 5, and in particular Application Note F, and weighing up a number of risks and their economic effects.

FRS 102

Under FRS 102, the arrangement should be analysed to determine whether it conveys the right for Company D to use the substation in return for payments. In this case, Company D has obtained the right to use the substation because it has been built only to meet its needs. It should therefore be accounted for as a lease. Depending on the details of the arrangement, both parties would account for the arrangement either as an operating lease (with Company C showing income and Company D showing expense relating to the use of the substation, distinct from that for the supply of electricity) or as a finance lease, so the substation would be shown as an asset on Company D's books rather than Company C's. If it is a finance lease, Company C would recognise a receivable equal to the net investment in the lease.

Current UK accounting standards focus on the likelihood of their being variations in the profits or losses (or cash flows) arising from the use of the property subject to the arrangement and FRS 102 focuses on whether there is a right to use the specific asset. However, in considering whether an entity has a right to use an asset, it is likely entities will consider factors such as the variability of the price to be paid. In both cases the intended result is the recognition of the substance of the arrangement and UITF Information Sheet 86 *Status of Adoption into UK GAAP of IFRIC Interpretations* (recently updated as http://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Status-of-Adoption-into-UK-GAAP-of-IFRIC-Interpret.aspx) noted that IFRIC 4 (from which these requirements of FRS 102 were developed) is already addressed in UK GAAP.

However, entities with service contracts (such as outsourcing arrangements, telecommunication contracts that provide rights to capacity, and take-or-pay contracts) should review whether they have a right to use certain assets when applying FRS 102 for the first time.

Example 3
Outsourcing arrangement

Facts

Company E has outsourced elements of its finance function, which are now provided by Company F. Company F uses a standard finance system for all its clients (Company F is not reliant on business from Company E), and provides data in a way which interfaces with the systems retained by Company E.

FRS 5

Although further details of the arrangement would need to be considered, it is likely that Company E would account for this as an operating cost. Company F would not show a lease, but would account for any fixed assets.

FRS 102

This outsourcing arrangement appears to be a contact for services that does not transfer the right to use the assets (Company F's finance system) from Company F to Company E, for example because Company F uses it to provide services to a large number of clients. A contract for services would be accounted for as an operating cost.

For outsourcing arrangements that are contracts for services (ie they do not confer a right to use assets) there is unlikely to be any change in accounting when applying FRS 102 for the first time.

Accounting for finance leases

Initial recognition

SSAP 21	FRS 102
At the inception of the lease the sum to be recorded as both an asset and a liability should be the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease. (SSAP 21 paragraph 32) In practice the fair value of the asset will often be a sufficiently close approximation to the present value of the minimum lease payments and may in these circumstances be substituted for it. (SSAP 21 paragraph 33)	At the commencement of the lease term, a lessee shall recognise its rights of use and obligations under finance leases as assets and liabilities … at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments, determined at the inception of the lease. (FRS 102 paragraph 20.9) The present value of the minimum lease payments should be calculated using the interest rate implicit in the lease. If this cannot be determined, the lessee's incremental borrowing rate shall be used. (FRS 102 paragraph 20.10)
Inception of a lease The earlier of the time the asset is brought into use and the date from which rentals first accrue. (SSAP 21 paragraph 29)	***Commencement of the lease term*** The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate). The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. (FRS 102 Glossary) Lease classification is made at the inception of the lease. (FRS 102 paragraph 20.8)

FRS 102 requires finance leases to be recognised at amounts equal to the fair value of the leased asset, or if lower, the present value of the minimum lease payments. In contrast, SSAP 21 requires measurement at the present value of the minimum lease payments, but as a practical expedient permits the use of the fair value of the asset (where it is a sufficiently close approximation). On application of FRS 102, entities may need to consider the measurement of finance lease obligations on initial recognition more carefully. However, in cases where the fair value of the leased asset was deemed a sufficiently close approximation to the present value of the minimum lease payments, there is unlikely to be a material difference between the two.

For most leases, the date of inception of the lease in accordance with SSAP 21 and the date of the commencement of the lease term in accordance with FRS 102 will be the same. However, it is possible, that the timing of the initial recognition of the asset and lease obligation will differ on application of FRS 102. For example, if a lessee signs a lease agreement on 1 January 20X1 but cannot start using the lease until 1 June 20X1, under FRS 102, the inception date would be 1 January 20X1 but the commencement date would be 1 June 20X1. The asset and lease obligation would not be recognised until the commencement date of 1 June 20X1. Under SSAP 21, the asset and lease liability would be recognised on 1 January 20X1.

Accounting for operating leases

Operating lease incentives

UITF 28	FRS 102
Operating lease incentives for lessors (a reduction against rental income) and lessees (a reduction against rental expense) should be allocated over the lease term or a shorter period ending on the date from which it is expected the prevailing market rental will be payable. The allocation should be on a straight line basis unless another systematic basis is more representative of the time pattern of the benefit receivable/received from the use of the asset. (UITF Abstract 28 paragraphs 14 and 15)	Operating lease incentives for lessors (a reduction against rental income) and lessees (a reduction against rental expense) shall be recognised over the lease term on a straight line basis unless another systematic basis is more representative of the time pattern of the benefit receivable/received from the use of the asset. (FRS 102 paragraphs 20.15A and 20.25A) Lease term is defined as 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)

In both cases, lease incentives are recognised on a straight line basis unless another systematic basis is more representative. The key difference is that the period over which operating lease incentives are recognised may be longer under FRS 102, for example where the lease term is 5 years, yet a rent review may take place after 2 years.

Disclosures

SSAP 21	FRS 102
The lessee should disclose the payments which he is committed to make in the next year, analysed between those in which the commitment expires within that year, in the second to fifth years inclusive, and over five years from the balance sheet date, showing separately the commitments in respect of leases of land and buildings and other operating leases. (SSAP 21 paragraph 56)	A lessee shall make the following disclosures for operating leases: (a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods: (i) not later than one year; (ii) later than one year and not later than five years; and (iii) later than five years. (b) lease payments recognised as an expense. (FRS 102 paragraph 20.16)

In both cases, companies (other than those subject to the small companies' regime) would be required to comply with Companies Act 2006 s410A. This requires disclosure, for material arrangements that are not reflected in the balance sheet, of:

- the nature and business purpose of the arrangements; and
- the financial impact of the arrangements on the company (not applicable to medium-sized companies).

Disclosure of operating leases will be different under FRS 102. The total future minimum lease payments due within each of the required periods will be disclosed, rather than the annual amount due to expire in the relevant year.