



LEASES UNDER FRS 102

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INTRODUCTION

This helpsheet has been issued by ICAEW's Technical Advisory Service to help ICAEW members understand key aspects of accounting for leases under FRS 102.

Members may also wish to refer to the following related helpsheets:

- [How does a lessee account for a rent free period under FRS 102?](#)
- [Covid-19-related rent concessions under FRS 102 and FRS 105](#)

WHAT IS A LEASE?

The glossary to FRS 102 defines a lease as 'An agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time'.

FRS 102 paragraphs 20.3 to 20.3A explain that some arrangements do not take the legal form of a lease but may nevertheless meet the definition in substance, and provide some guidance in identifying arrangements that may contain a lease. The key consideration is whether or not there is an agreement which conveys the right to use a **specific** asset in return for payments.

For instance, a contract where the supplier builds a fibre-optic network, and sells data transmission access to the purchaser for a ten-year period, could be characterised as a lease, since it conveys the right to use a specific and identifiable asset for a set period of time.

In contrast, consider a contract where a supplier provides access to, say, a photocopier, but has the right to replace the photocopier at any time with an alternative asset or to withdraw access to the asset altogether and simply provide the service themselves directly. This is likely to be a contract for a service rather than a lease. This is because it does not relate to one specific asset, but rather the provision of access to a service which may be delivered by any suitable asset.

A contract which includes the right to use a specific asset as well as services should be separated when the two (or more) streams operate independently of each other. In such cases, Section 20 of FRS 102 should be applied only to the part relating to the provision or use of the asset.

Section 20 of FRS 102 also scopes out a number of arrangements, including licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights which are dealt with as intangible assets under Section 18 Intangible assets other than goodwill.

FINANCE LEASE OR OPERATING LEASE?

A lease is classified as a finance lease when substantially all of the risks and rewards incidental to ownership are transferred to the lessee (FRS 102 paragraph 20.4) - there is no bright line test and judgement may therefore be required. FRS 102 includes a number of examples in paragraph 20.5 of situations that individually or in combination may lead to a lease being classified as a finance lease:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- 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;
- the lease term is for the major part of the economic life of the asset;
- 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; **and**
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Further indicators are included in paragraph 20.6.

FINANCE LEASES

Lessees

At the commencement of the lease term, a lessee shall recognise its rights of use and obligations under finance leases as assets and liabilities in its statement of financial position 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).

Subsequently, a lessee apportions the minimum lease payments between the finance charge and the reduction of the outstanding lease liability using the effective interest method (FRS 102 paragraph 20.11). The allocation should produce a constant periodic rate of interest on the remaining balance of the liability. Members may wish to refer to the **Amortised cost calculator** for assistance in using the effective interest method.

Lessors

Lessors recognise as an asset the net investment in the lease (FRS 102 paragraph 20.17). Subsequently, the recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease (FRS 102 paragraph 20.19).

OPERATING LEASES

From both a lessor and lessee perspective, the operating lease income or expense is generally recognised on a straight-line basis over the lease term in accordance with FRS 102 paragraphs 20.25 and 20.15 respectively. There are, however, exceptions where another systematic basis is representative of the time pattern of the user's benefit, where payments are structured to increase in line with expected general inflation or where COVID-19-related rent concessions have been granted.

Payments structured to increase in line with expected general inflation

In general, under FRS 102, the total cost of entering into an operating lease for a lessee should be spread on a straight-line basis over the lease term. However, FRS 102 paragraph 20.15(b) allows that, if payments under the lease have been structured to increase with general inflation, a lessee can recognise lease payments in line with that pattern instead.

In order for this option to be available, the contractual payments in the lease agreement must state that the lease payments increase by a specified amount which has been clearly linked to expected increases in general inflation. For example, a lease which states clearly that 'payments will increase by 3% per annum in line with expected inflation' would qualify under this paragraph, since it is known at inception of the lease what the future payments will be.

It is important to distinguish this, though, from a lease which states that 'payments will increase by RPI'. In this example, the amount of the increase, while linked to inflation, is not explicitly specified at the outset. It is not known what RPI will be in the future and therefore this is an example of contingent rent, which can only be recognised as incurred, i.e. once the effect is actually known.

COVID-19-related rent concessions

In October 2020, the FRC introduced amendments to FRS 102 with respect to temporary rent concessions granted as a result of the COVID-19 pandemic. Guidance on the accounting for such concessions is available in the helpsheet [Covid-19-related rent concessions under FRS 102 and FRS 105](#).

Lease incentives

Under FRS 102, lease incentives must be spread over the lease term. Lease incentives can take many different forms, however the most common form of lease incentive is a rent free period. Guidance on accounting for a rent free period is available in the helpsheet [How does a lessee account for a rent free period under FRS 102?](#)

It is important to note the difference between the terms 'break clause' and 'on-market rent review'. A break clause is an option for either the lessee or the lessor (or both) to end the lease early. This may coincide with a rent review, but this is not always the case. Under FRS 102, a rent review does not affect the period over which a lease incentive is spread. However, a break clause could affect it because it may affect what is considered to be the 'lease term'.

WHAT IS THE LEASE TERM

Definition

Lease term is defined in the glossary of FRS 102 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'.

The definition of lease term is the same under FRS 105 and therefore the application is the same under both FRS 102 and FRS 105.

Considerations

Significant judgement is often required when assessing the lease term where the lease contains break clauses or options to extend the lease agreement. At the inception of the lease, consideration should be given to all relevant factors including, but not limited to:

- Contractual rental payments for any optional periods (e.g. periods covered by an option to extend or before which a break clause could be exercised) compared with market rates;
- The nature and extent of any planned leasehold improvements;
- Costs relating to the termination of the lease (e.g. termination penalties, negotiation costs and relocation costs); **and**
- The importance of the leased asset to the operations of the entity.

Example

An entity has taken out a 10 year lease on a property and has the option to exercise a break clause after 7 years.

The non-cancellable period for which the lessee has contracted to lease the asset would therefore be 7 years. The lessee has the option to continue to lease the property for a further 3 years (by not exercising the break clause).

The entity will need to assess whether, at the inception of the lease, it is reasonably certain that it will continue to lease the asset for the further 3 year period.

- If it was reasonably certain to do so, then the lease term would be 10 years (the 7 year non-cancellable period the lessee has contracted to lease the property for plus the additional 3 years it has the option to continue to lease the property for if it does not exercise the break clause).
- If it was **not** reasonably certain to do so, then the lease term would be 7 years (just the non-cancellable period the lessee has contracted to lease the property for).

Disclosure – lessees

The disclosure requirements contained in FRS 102 paragraph 20.16 require lessees to disclose the **total** of future minimum lease payments under non-cancellable operating leases analysed based on when the payments are to be made, as well as disclosing the lease payments recognised as an expense.

Entities applying FRS 102 1A will need to adhere to paragraph 1AC.29 which requires disclosure of the total financial commitment. Many entities will elect to provide additional disclosure to explain the commitment and indeed this would be mandatory where required to achieve a true and fair view.

Disclosure – lessors

The operating lease disclosure requirements for lessors are stated in FRS 102 paragraphs 20.30 and 20.31. Lessors need to disclose the future minimum lease payments under non-cancellable operating leases analysed based on when the payments are to be made, total contingent rents recognised as income and a general description of the lessor's significant leasing arrangements.

IF IN DOUBT SEEK ADVICE

ICAEW members, affiliates, ICAEW students and staff in eligible firms with **member firm access** can discuss their specific situation with the Technical Advisory Service on +44 (0)1908 248 250 or via **webchat**.

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