

Lease accounting changes – next steps for charities.

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FRS102 – periodic update

- Published December 2022
- Reflecting changes in IFRS accounting standards particularly on:
 - leases
 - revenue
 - other incremental improvements & clarifications.
- **Effective date – 1 January 2026**



Leases

Leases - headline

- Significant changes for lessees -the IFRS 16 model of 'on-balance sheet' leasing model for lessees but with simplifications.
- Lessees will be required to recognise a right-of-use asset and a lease liability for all its leases
- Exemptions available for short term leases and those where the underlying asset is of low value
- Significant impact on charities with large numbers of leases
- Not much of an impact for lessors
- Significant increase in the level of disclosures required

 https://media.frc.org.uk/documents/Factsheet_11_-_Lease_accounting_for_lessees.pdf

Identifying the lease



Lessee

Identifying a lease

A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Assess throughout the period of use if it has both the following:

- The right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use; **and**
- The right to direct the use of the identified asset throughout the period of use.

As the definition of a lease has not changed, anything which has previously been identified as an operating lease will most likely be a lease under the new accounting framework.

What about leases for nominal, nil or peppercorn consideration?

Exemptions

Short term leases and low value assets

If the elections applied the lease payments recognised as an expense on a straight-line basis over the lease term or another systematic basis if that is more representative of the pattern of the benefit

Short term leases

- At the commencement date, has a lease term of 12 months or less
- Leases containing a purchase option are not short-term leases
- If there is a lease modification or a change in the lease term considered a new lease
- Election made by class of asset

Low value assets

- Exemption may be applied even if leases are material to the lessee
- Assessed based on the value of the underlying asset- not the value of the lease payments
- No quantitative threshold for low value
- Assess either on an absolute or lease-by-lease basis
- Can only be low value if the lessee can benefit from the asset on its own **and** the assets is not dependent on or highly interrelated with other assets

Assets excluded from low value exemption

- Cars, vans, buses, coaches, trams, trucks, and lorries.
- Cranes, excavators, loaders and bulldozers.
- Telehandlers and forklifts.
- Tractors, harvesters and related attachments.
- Boat and ships.
- Railway rolling stock.
- Aircraft and aero engines.
- Land and buildings.
- Production line equipment.

Lessee accounting

Portfolios of leases

As a practical expedient the standard may be applied to a portfolio of leases with similar characteristics where it reasonably expects the effect of applying the standard to the portfolio would not differ materially from applying the standard to the individual leases.

Rainbow Charity

- Enters into 10 equipment leases in 2024
- Leases vary in size from £20k to £80k
- Lease terms are all for 5 years
- All the assets are located in the UK

Lease terms are similar and the incremental borrowing rates are also likely to be similar. Portfolio accounting may well be appropriate as the difference is unlikely to be material.

Caritas

- Enters into 10 property leases in 2024
- Leases vary in size from £1m to £3.5m
- Lease terms vary between 7 and 15 years
- Assets are located in the UK, France, Hong Kong and Brazil

Lease terms vary significantly and the incremental borrowing rates are likely to differ. Portfolio accounting is unlikely to be appropriate.

Separating components

When a contract is, or contains, a lease, a charity must account for each lease component as a lease separately from the non-lease components.

The right to use an underlying asset is considered as a separate lease component if **both** of the following conditions are met:

- The lessee can benefit from the use of the underlying asset on its own or together with other readily available resources. **AND**
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

Lessees have the option to apply a practical expedient that permits them to elect not to separate lease and non-lease components. Instead, the lessee can account for each lease component and any associated non-lease components as a single lease component .

This election must be made by class of underlying asset. If the lessee does not apply this practical expedient, they must account for the non-lease components in accordance with other relevant sections of FRS 102.

Determining the lease term



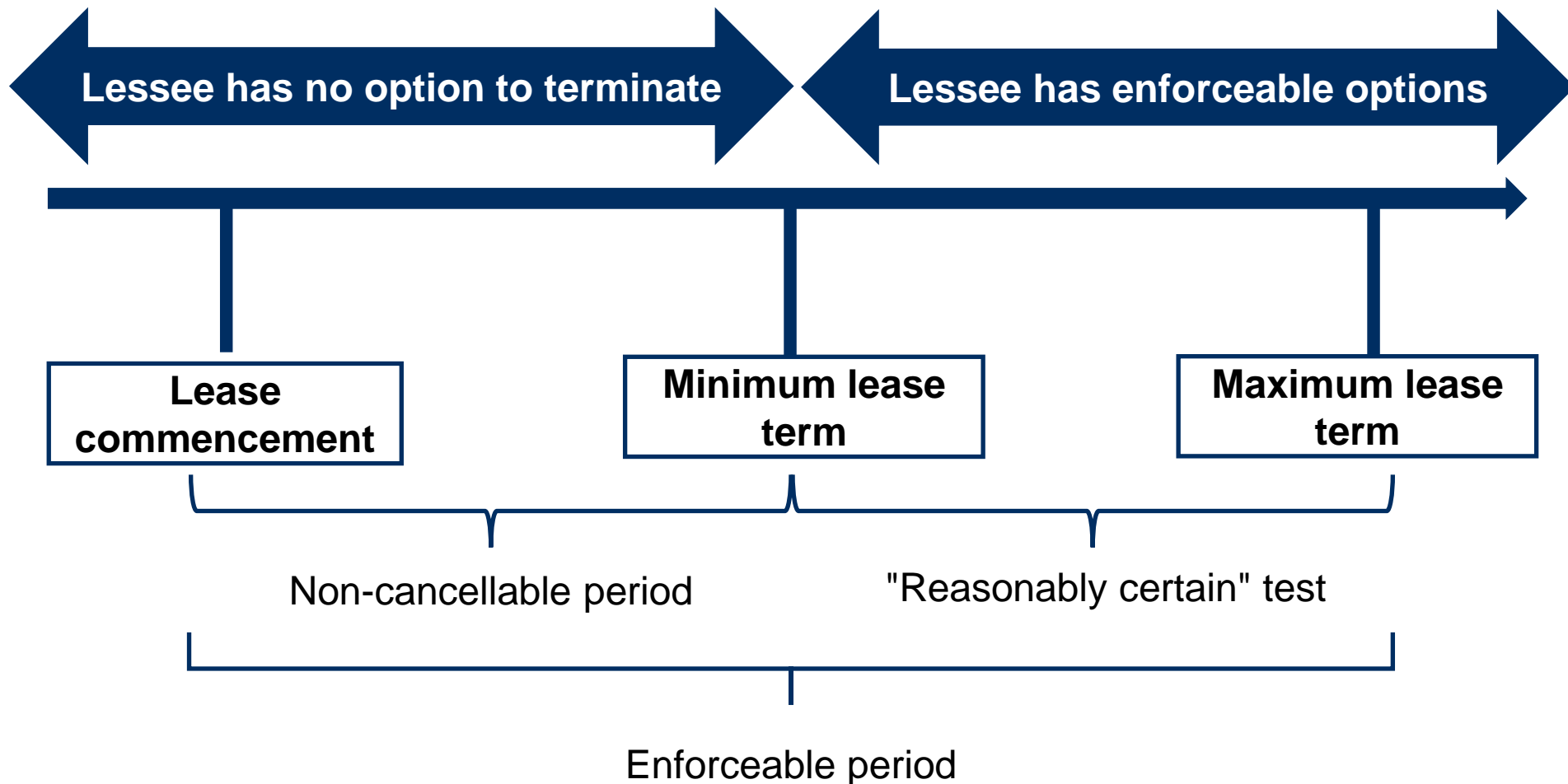
Lessee

Determining the lease term

The lease term is the aggregate of the non-cancellable period of a lease, together with:

- periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise that option;
and
- periods covered by an option to terminate the lease if the lessee is *reasonably certain* not to exercise that option.

Components of the lease term



Lease options

Reasonably certain test

- No definition of reasonably certain and past practice can provide an insight
- Factors to consider include:
 - The specialised nature of the underlying asset.
 - The contractual terms and conditions compared with market rates.
 - The availability of suitable alternatives to the underlying asset.
 - The existence of significant leasehold improvements expected to have significant economic benefit when exercising options.
 - The costs associated with terminating the lease.
 - The importance of the underlying asset to the lessee's operations.
 - The conditionality associated with exercising the option.

Calculating the lease liability

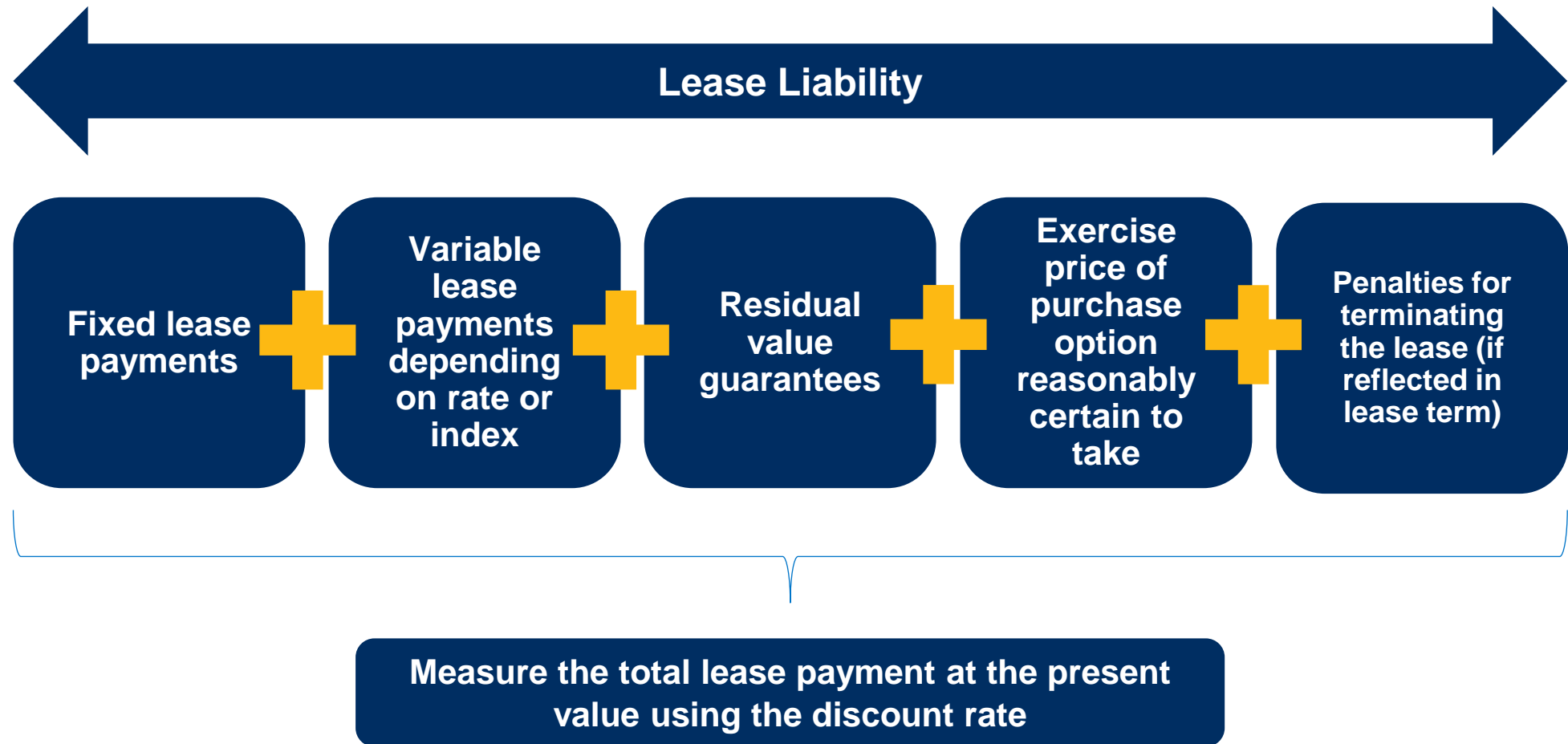


Lessee

Calculation of lease liability



Initial measurement of lease liability



Lessee

Recognition and measurement at commencement date

Right-of-use asset

- Right-of-use ('ROU') asset initially measured at cost comprising;
- Initial measurement of lease liability
 - Initial direct costs incurred
 - Any lease payments made before the commencement date less any incentives received
 - Estimate of costs to be incurred in dismantling, removing or restoring the asset as a condition of the lease.

Lease liability

- Present value of the lease payments that are not paid at that date.
- Includes residual value guarantees.
- The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

Residual value guarantees

Example – agricultural programme

A charity leases a tractor for two years for use in its agricultural programme. The lease agreement includes a residual value guarantee agreed by both the lessee and lessor. If the fair value of the tractor at the end of the lease term is below £10,000, the charity must make a payment for the difference between the fair value of the tractor and £10,000.

At the commencement of the lease, the charity anticipates the tractor's fair value will be £9,500 at the end of the two-year term.

Therefore, the charity includes £500 in the lease payments in respect of the residual value guarantee when determining the lease liability.

Discount rates

Discount using rate implicit in the lease; where not possible then on a lease-by-lease basis:

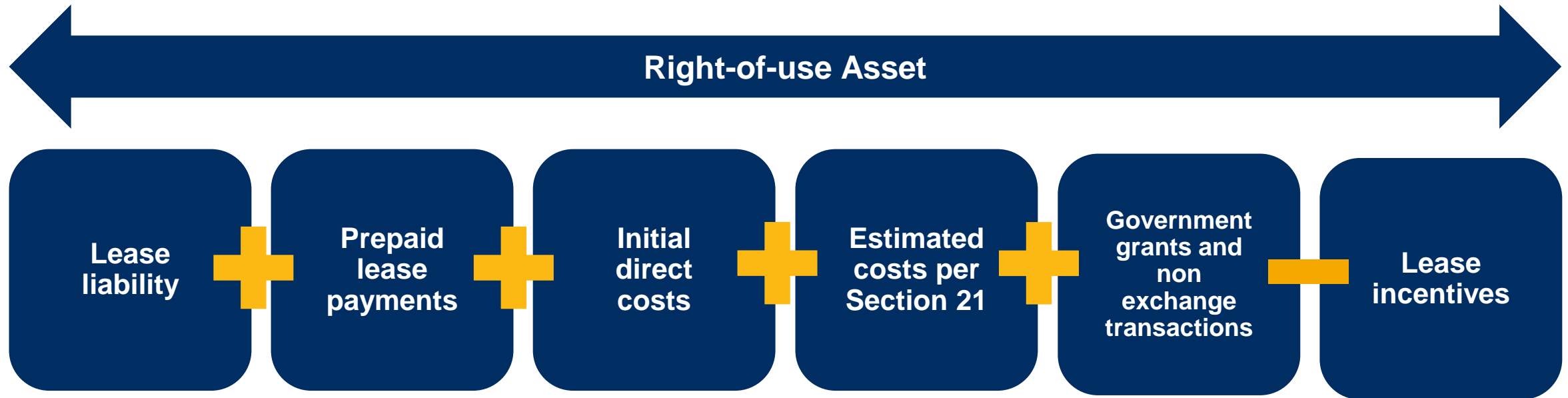
- Use the lessee's incremental or obtainable borrowing rate or
- The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow over a similar term

Where public benefit entities may be unable to determine either the interest rate implicit in the lease, or the lessee's incremental or obtainable borrowing rate for a lease, on the basis that they do not borrow, these entities should use the rate of interest available to them on deposits held with financial institutions.

Calculating the right-of-use asset



Initial measurement of right-of-use asset



Direct costs

- Initial direct costs, as defined by FRS 102, are incremental costs incurred specifically to obtain a lease that would not have been incurred if the lease had not been obtained. Costs that are directly attributable to obtaining a lease, which would be incurred regardless of whether the lease is ultimately secured, do not qualify as direct costs.

Nature of costs	Direct cost?
Legal fees: legal fees incurred on negotiating the leases terms and conditions (these fees only materialised if the lease was successfully obtained)	Yes
Commission: commission paid to a leasing agent for successfully securing the lease.	Yes
Costs of arranging collateral: cost incurred to arrange collateral required by the lessor as part of the lease agreement	Yes
Due diligence checks	No
General overhead costs of facilities team	No
Costs of obtaining lease offers	No

Restoration costs

- A lessee shall recognise costs incurred by the lessee in dismantling, removing, or restoring an asset as part of the cost of the right-of-use asset when it incurs an obligation for those costs. This obligation may arise at the commencement date or at a subsequent date.
- These costs include dismantling and removing the underlying asset, restoring the site on which it is located, or restoring the underlying asset to the condition required by the terms and conditions of the lease.
- An asset may suffer wear and tear throughout the lease term due to the use of the right-of-use asset to produce inventory. This may increase the expected restoration costs the lessee is obliged to pay. However, these do not typically impact the right-of-use asset cost calculations and instead will be expensed in the period incurred.

EXAMPLE

A charity leases a building for 12 years to use as its head office. Significant modifications are made by the charity, including the installation of partitions and networking equipment. Under the lease agreement, the charity must restore the building to its original condition at the end of the lease.

At the commencement date, the charity estimates the restoration costs to be £15,000 for the removal of the partitions and networking equipment, repainting and replacement of carpets.

The charity therefore recognises the present value of £15,000 as a provision per Section 21 of FRS 102 and includes in the cost of the right-of-use asset.

Subsequent measurement



Lessee

Recognition and measurement at subsequent dates

Right-of-use asset

- Cost less depreciation and impairment adjusted for any remeasurement of the lease liability.
- Typical depreciation period is earlier of end of the asset's useful life or the end of the lease term.

Lease liability

- Increase carrying amount to reflect interest on the lease liability;
- reduce carrying amount to reflect the lease payments made; and
- remeasure carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.

Example

Food bank

- Lease building to operate a food bank for five years.
- Annual lease payments of £15k.
- Incremental borrowing rate of 4%.
- Initial lease liability of £66,777.
- At the end of year one, the lease liability has a carrying amount of £54,448.
- Interest of £2,671 is recognised in the SOFA

Year	Lease Payment	Discount Rate (4%)	Discounted Payment
1	£15,000	0.96154	£14,423
2	£15,000	0.92456	£13,868
3	£15,000	0.88900	£13,335
4	£15,000	0.85480	£12,822
5	£15,000	0.82193	£12,329
			£66,777

Initial lease liability	£66,777
Interest (£66,777 x 4%)	£2,671
Lease payment	(£15,000)
Carrying amount of lease liability at end of year 1	£54,448

Example 2

Community kitchen

- Leases building to operate a community kitchen for 5 years
- Option to extend the lease for 3 years
- At the commencement date, not reasonably certain of extending the lease
- The annual lease payments are £17k
- Incremental borrowing rate of 6%.

Initial lease liability of £71,610

End of year 1 – interest of £71,610* 6% = £4,297

End of year 1 – lease liability of £58,907

Year	Lease Payment	Discount Rate (6%)	Discounted Payment
1	17,000	0.94340	16,038
2	17,000	0.89000	15,130
3	17,000	0.83962	14,274
4	17,000	0.79209	13,466
5	17,000	0.74726	12,703
			71,610

Example 2

Community kitchen

Receives a significant grant at the end of year 1

Charity reasonably certain to extend lease by 3 years

Incremental borrowing rate of 5%

Extended lease term is 7 years

Lease liability remeasured

PV of 6 payments of £17k discounted by 5%

Therefore £86,287

Adjustment of £27,380 to lease liability

Year	Lease Liability B/F	Discount Rate	Lease Payment	Interest Expense	Subs. Measurement	Lease Liability
1	71,610	6%	17,000	4,297	27,380	86,287
2	86,287	5%	17,000	4,314	-	73,601
3	73,601	5%	17,000	3,680	-	60,281
4	60,281	5%	17,000	3,014	-	46,295
5	46,295	5%	17,000	2,315	-	31,610
6	31,610	5%	17,000	1,580	-	16,190
7	16,190	5%	17,000	810	-	-

Arrangements below market rate or for nominal amounts



Nominal or peppercorn arrangements

Peppercorn arrangements – in this SORP such arrangements are considered to have the legal form of a lease, but with nil or nominal consideration and are unlikely to meet the FRS 102 definition of a lease but are considered therefore to be a form of non-exchange transaction.

Any nominal payments that are made are treated as an operating expense and are outside the scope of Section 20 of FRS102.

The charity must consider the substance of the arrangement and how to account for it. Consideration of the use of the asset, facility or service and whether the charity would have purchased it if the nominal arrangement had not been entered into will be helpful. For example:

- If the arrangement means that an asset is available to the charity to use to carry out its charitable activities, the charity will need to identify the fair value of that asset and account for a donated asset in line with the treatment described in SORP module 6.
- If the arrangement means that a facility or service is now available to the charity, the value to the charity of the facility or service is used and a donation recognised for that amount. Details about the donation of facilities and services can be found in SORP module 6.

Social donation leases

- Lease arrangements where the payments are below market rate but are higher than a nominal amount as a result of the lessor choosing to accept a lower rent for the philanthropic intention of providing a benefit to the lessee are social donation leases. A charity may enter into a social donation lease either as a lessee or lessor.
- Social donation leases, by definition, contain a non-exchange component. The measurement of the non-exchange component will take into account the lease payments that are actually made and:
 - Where the incoming resource is an asset, the fair value of that asset; or
 - Where the incoming resource is a service or facility, the value of that service or facility to the charity.
- The value of the incoming resources from the non-exchange component is recognised as part of the cost of the right-of-use asset (see paragraph 10B.48) when the resources are received or receivable.
- The incoming resources from the non-exchange component forms part of the cost of the right of use asset.



Disclosures

“Where a charity has any leases classified as social donation leases or peppercorn arrangements, this SORP requires the charity to provide a general description of the lease term, the remaining term if not a perpetual lease, any restrictions or conditions as to the use of the right-of-use asset and the presence of any reversion clauses. In addition, where a charity has incoming resources from a non-exchange transaction as part of a social donation lease, it must fulfil the disclosure requirements set out in paragraph 6.32 of this SORP in respect of those resources and where key judgements have been made by the charity in applying the relevant accounting policies to those resources, the disclosure requirements set out in paragraph 3.54 of this SORP must also be followed.”

Leases as a social investment

A charity entering into a finance lease at below market rate to a lessee is making a social investment and is in substance offering a concessionary loan to the lessee. Under this SORP, the measurement of the net investment in the lease and recognition of the finance income is the same as a finance lease but this SORP requires the charity to class these as a separate component of its concessionary loans (refer to SORP module 21 Accounting for social investments).

A charity entering into an operating lease as a social investment is making an asset available on concessionary terms but its treatment is no different to that of any other operating lease. While the lease payments may be significantly below market rates, this is unlikely to be an indicator of impairment of the asset because the asset is performing its intended purpose of providing social or charitable benefit.



Examples

The lessor states that as part of its corporate social responsibility activities, it will give the charity a 50% discount on the office space, so the charity will pay £60,000/year instead. If the arrangement not been available, the charity expected to pay £72,000/year for office space elsewhere.

The information available to the charity indicates there is a nonexchange component in the lease. Where the charity determines that it is a facility it has received under this arrangement, it is the value to the charity of the office space that is important. The non-exchange component is £12,000/year – the difference between the value to the charity and the payment being made. Assuming no performance-related conditions exist in the arrangement, the charity will recognise the income when it is received or receivable. This will usually be at the commencement of the lease but may be over the term of the lease depending on the terms of the arrangement.

The lessor states that as part of its corporate social responsibility activities, it will allow the charity to use the office space for a nominal consideration of £10/year.

Had this arrangement not been available, the charity expected to pay £72,000/year for office space elsewhere.

The payments made by the charity are very small so the arrangement does not meet the definition of a lease as there is no substantive consideration being paid.

The availability of the facility to the charity is treated as a donation of £71,990 per year – the value to the charity less the consideration paid.

Disclosures



Lessee – disclosure primary statements

Balance Sheet




	Old FRS102 £		New FRS102 £
	Finance Leases	Operating Leases	All leases
Assets			
Liabilities			£
Off balance sheet rights/ obligations	£	£ 	

Diagram illustrating the transition of lease accounting from Old FRS102 to New FRS102 for a lessee. In the Old FRS102, Finance Leases are recorded as Assets and Liabilities, while Operating Leases are off-balance sheet. In the New FRS102, all leases are consolidated into a single 'All leases' category on the balance sheet. Arrows show the reclassification: Finance Leases Assets and Liabilities move to 'All leases', and Operating Leases (previously off-balance sheet) also move to 'All leases'.

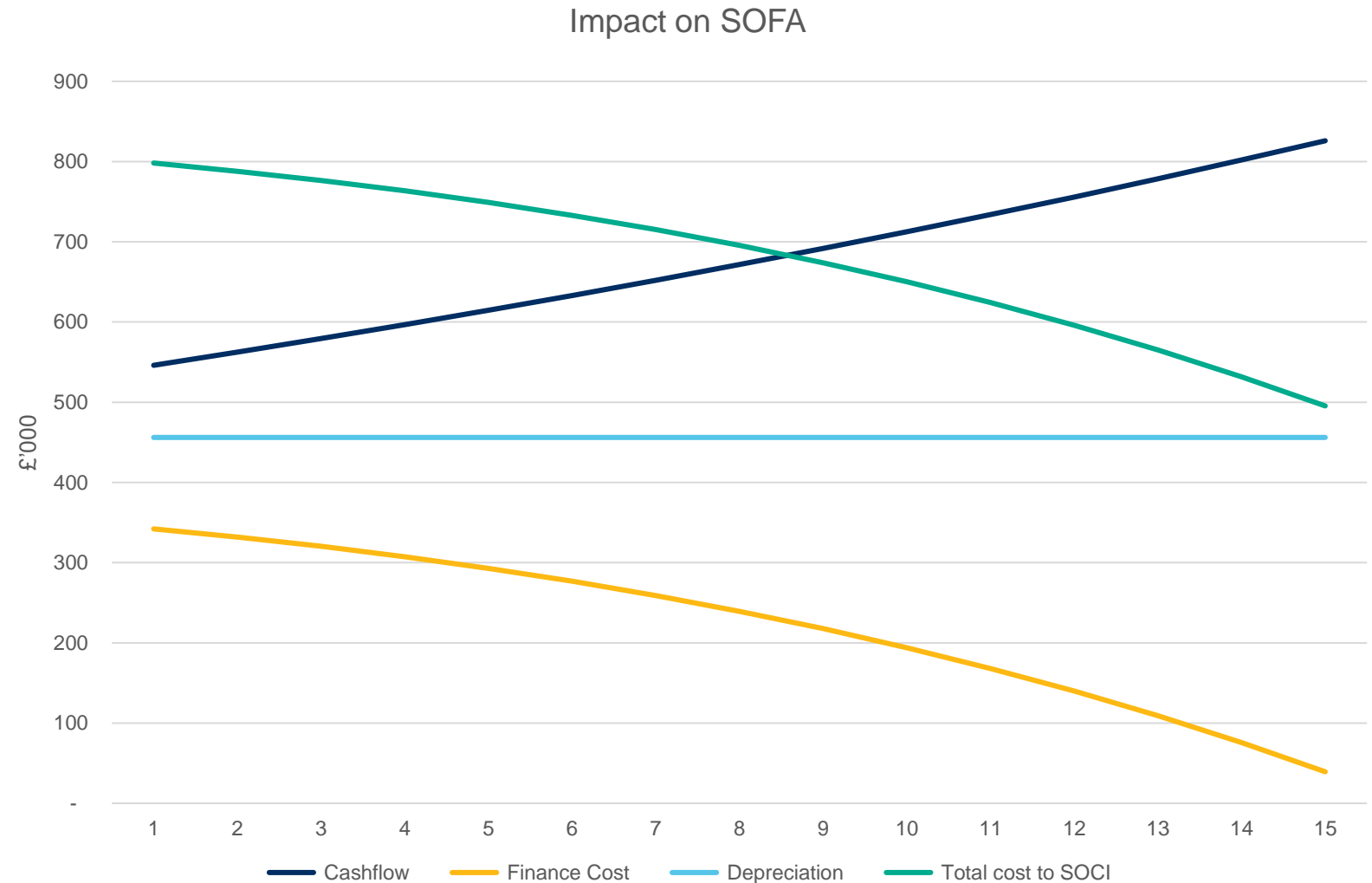
Statement of financial activities ('SOFA')

	Old FRS102 £		New FRS102 £
	Finance Leases	Operating Leases	All leases
Income	x	x	x
Operating costs (excluding depreciation & amortisation)		Single Expense	
Depreciation & Amortisation	Depreciation		Depreciation
Finance costs	Interest		Interest
Net income/expenditure			

Diagram illustrating the transition of lease accounting from Old FRS102 to New FRS102 for a lessee in the Statement of Financial Activities (SOFA). In the Old FRS102, Finance Leases result in Interest expense, and Operating Leases result in a Single Expense. In the New FRS102, all lease-related costs are consolidated into 'All leases'. Arrows show the reclassification: Operating Lease Single Expense and Finance Lease Interest move to 'All leases' Interest, and Finance Lease Depreciation moves to 'All leases' Depreciation.

Lessee: FRS102 example impact on SOFA

- Depreciation (straight line of life of the lease)
- Interest expense (finance cost)



Lessee

Implications for financial metrics

Metric	What it measures	Common method of calculation	Expected effect of new FRS 102	Explanation
Leverage (gearing)	Long-term solvency	Liabilities/reserves	Increase	Increase because financial liabilities increase (and reserves expected to decrease)
Current ratio	A lease is classified as an operating lease	Current assets / current liabilities	Decrease	Decrease because current lease liabilities increase while current assets do not
Interest Cover	Long-term solvency	EBITDA / Interest expense	Depends	EBITDA will increase as will interest expense Interest cover will change over the lease term
EBITDA	Profitability	Various methods	Increase	Change in disclosure of lease payments (old FRS102) to depreciation and interest (new FRS102)
Operating cash flow	Profitability	Cashflow from operating activities does not include cash related to borrowings	Increase	Increase because at least part of the lease payments (those relating to the principal) will be moved to the financing section of the cash flow statement

Lessee accounting disclosures

- Either present separately on balance sheet or include within the same line that it would be if owned and disclose which line and disclose in the notes
- Lease liability separate from other liabilities either on face of balance sheet or in the notes
- If meet definition of investment property, then present as an investment property on the balance sheet
- Disclose the detail of lots of other things like discount rates, variable lease payments or guarantees – anything that is a judgement in other words
- Interest expense on liabilities – SOFA
- Expense relating to short term leases or low value assets where applied recognition exemption and practical expedients and other recognitions exemptions
- Also, cashflow statement disclosures...

Disclosures example

Balance sheet

	Note	2024	2023
Fixed Assets		£'000	£'000
Intangible assets	7	x,xxx	x,xxx
Tangible fixed assets	8	xx,xxx	xx,xx x
Right of use assets*	9	x,xxx	x,xxx
Investments	10	xx,xxx	xx,xx x

The right-of-use assets related to the agricultural equipment are presented as property, plant and equipment:

	Agricultural Equipment	Total
	£'000	£'000
Brought forward balance at 1 January 2024	xx,xxx	xx,xxx
Depreciation charge for the year	(xx,xxx)	(xx,xxx)
Additions to right-of-use assets	xx,xxx	xx,xxx
Carried forward balance at 31 December 2024	xx,xxx	xx,xxx

Amounts recognised in the profit or loss

	2024	2023
	£'000	£'000
Interest on lease liabilities	xxx	xxx
Expenses relating to leases of low-value assets	x,xxx	x,xxx

Amounts recognised in the statement of cash flows

	2024	2023
	£'000	£'000
Operating Cash Flows		
Payments for low-value leases	xxx	xxx

Lessor

A lessor shall classify each of its leases as either an operating lease or a finance lease.

Finance Lease	A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating Lease A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Transition & preparation



Transitional Arrangements

- Applicable for periods commencing on or after 1 January 2026 – therefore 31 December 2026, 31 March 2027
- Not a prior year adjustment
- But recognise the cumulative effect of the initial application as an adjustment to the opening balance of reserves at the date of initial application
- Lessees: leases previously classified as operating leases For each lease previously classified as an operating lease, a charity must:
 - Recognise a lease liability at the date of initial application calculated based on the present value of the remaining lease payments using a discount rate
 - Recognise a right-of-use asset at the date of initial application measured at an amount equal to the lease liability adjusted for any prepaid or accrued lease payments.
- Account as short term leases where the right of use asset lease term ends within 12 months of the date of transition
- Can use hindsight when considering terms of lease or options to extend or terminate

FRS102

Leases - preparation

1. Review all leases – operating leases at adoption will be recognised on the balance sheet
2. Consider simplification options (short term leases and low value assets)
3. Lease liability is the present value of lease payments not yet made
4. Discount using the rate implicit in the lease or, if that cannot be readily determined, the lessee's incremental borrowing rate
5. Lots of new disclosures and whilst not a PYA, changes to comparative and opening balances
6. Consider financial impact on cashflow statement and any bank loans/covenants
7. Audit trail and evidence

- There are a lot of judgements
- Lots of new disclosures
- Lots of arithmetical calculations

How long will it take?
Depends on how many leases you have and how complicated they are.



Q&A



Thank you

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