Transition time

With the change to FRS 102: The Financial Reporting Standard applicable in the UK and Republic of Ireland upon us, ***Stephanie Matthews*** considers the implications this will have when accounting for lease commitments.

TEN SECOND SUMMARY

1. **Finance leases and operating leases and the difference between them.**
2. **Accounting for leases and some practical examples.**
3. **The disclosure requirements for finance and operating leases.**

After more than six years of consultation, 1 January 2015 marked the largest change in the UK accounting profession for decades. Many of us felt saddened to see the old statements of standard accounting practice (SSAPs) and financial reporting standards (FRSs) that we knew and loved become but a distant memory. However, in its place FRS 102 promises a simplified reporting regime with more up-to-date and relevant accounting requirements that are less complex and onerous for SMEs.

One of the most significant changes, which will apply to most businesses, is in respect of accounting for leases.

Finance or operating?

FRS 102 (*The Financial Reporting Standard applicable in the UK and Republic of Ireland*) is similar to SSAP 21 (*Accounting for leases and hire purchase contracts*) because it also requires us to consider the risks and rewards of ownership when deciding whether a lease agreement is a finance lease or an operating lease. Those in which substantially all the risks and rewards of ownership of an asset are transferred will be classified as a finance lease. If the agreement does not transfer substantially all the risks and rewards of ownership it is classified as an operating lease.

There are several important factors to consider when assessing the risks and rewards of a lease agreement. The main one is whether the lessee has the right to use the asset for most, or all, of its useful economic life. Another is whether the lessee is required to insure, maintain and repair the asset.

When these considerations apply, the risks and rewards are transferred to the lessee and the agreement is classified as a finance lease. The commercial reality of such a transaction is the acquisition of an asset with financing from the leasing company. We would therefore recognise an asset and a liability on the statement of financial position.

However, FRS 102 does not contain the direct equivalent to the 90% test under SSAP 21, which allowed us to classify a lease as a finance lease if the value of the minimum lease payments was 90% or less of the fair value of the asset being leased.

Accounting for lease incentives

FRS 102 requires lease incentives and uplifts to be accounted for on a straight-line basis over the whole of the lease term, not just over the period to the first rent review as per SSAP 21.

Let us say that an entity enters into a 10-year lease over a building that has a life of 50 years. Lease rentals are £160,000 a year, with a rent review in year five. The lease contains an option to renew for a further five years at a rent to be negotiated, but not exceeding £160,000 a year. Under the terms, the landlord will contribute £140,000 towards alterations to the building to be made by the lessee. The alterations are for the purpose of the lessee's operations and do not represent a long-term enhancement of the value of the building.

In this example, the lease incentive is the £140,000 contribution from the landlord towards the building alterations.

Accounting treatment

Under UITF 28 (old UK GAAP), the lease incentive is spread over the period to the first rent review, which would be five years. As a consequence, the net rent charge to profit or loss in the first five years of the lease would be £132,000 (£160,000 – (£140,000 ÷ 5 years)).

FURTHER INFORMATION

FRS 102: http://www.lexisurl.com/frs102
SSAP 21: www.lexisurl.com/SSAP21

By comparison, under FRS 102 (new UK GAAP) the lease incentive is spread over the entire lease term, regardless of whether there is a rent review. The net rent charge to the profit of loss for the entire lease term is therefore £146,000 (£160,000 – (£140,000 ÷ 10 years).

Arrangements containing a lease

SSAP 21 applied only to leases, which were defined as arrangements forming a contract for the hire of a specific asset between a lessor and lessee. However, FRS 102 recognises that, although some arrangements may not take the legal form of a lease, the substance of the contract may convey the right to use an asset often with related services, such as outsourcing arrangements, telecommunications contracts and take-or-pay contracts.

The separate elements of such arrangements should be considered individually to establish whether there is a hidden or embedded lease, and the capital and revenue elements of such an agreement are accounted for separately. However, if the supplier is unable to split the capital and revenue elements the entire lease should be capitalised as a finance lease.

To illustrate, Company A has outsourced its IT equipment for five years, at an annual cost of £20,000. The outsource agreement contains two specific components and the annual cost can be split as follows.

- The supply of a server, which has been adapted to meet Company A's specific requirements, £5,000. The terms of the agreement state that Company A must insure the server and there is an additional charge for any maintenance work required.
- The supply and maintenance of 300 laptops, at standard specification, £15,000.

The agreement permits the supplier to replace the laptops at any time as long as there is no disruption to the IT services.

Accounting treatment

Under old UK GAAP, an expense for the outsourced cost in respect of this agreement would be recognised in the profit or loss on a straight line basis. FRS 102 (new UK GAAP) requires us to assess each element of such an arrangement to establish whether there is an embedded lease.

If we consider the server first, Company A has the right to control the use of the asset because it is on the business's premises for a set period. Therefore, the £5,000 outsource cost for this will be treated as a lease rental. Company A would need to determine whether the lease is finance or operating in nature. Because Company A is liable for insuring the server and must pay an additional fee for maintenance, the risks and rewards of ownership have been transferred to Company A. This is a finance lease and an asset and liability should be recognised.

Now we need to consider the laptops, which Company A does not have the right to control because they can be substituted at the discretion of the supplier. This is therefore an outsourcing cost and the £15,000 would be charged to the profit or loss.

Disclosure

FRS 102 requires the total future minimum lease commitment to be disclosed for operating leases, not just the annual lease cost, which was the requirement of SSAP 21.

The disclosure for finance leases remains unchanged under FRS 102.

Let us say that Company B prepares its financial statements to 31 December 2015. It rents its property under an operating lease which, at the end of the financial year, has three years to run at an annual cost of £30,000.

Accounting treatment

Under SSAP 21 (Old UK GAAP) at 31 December 2015 the company had annual commitments under non-cancellable operating leases as shown in ***Annual Commitments***.

Annual Commitments

	2015 £	2014 £
Within one year	30,000	30,000
Between two and five years	30,000	30,000
Later than five years	–	–

The treatment under FRS 102 (New UK GAAP) is that the company has entered into a rental agreement for its property, which is classified as an operating lease so it has obligations under this. At 31 December 2015, the lease has three years remaining (four years in 2014), with fixed monthly rentals over the same period. The future minimum lease payments are as shown in ***Lease Payments***.

Lease Payments

	2015 £	2014 £
Not later than one year	30,000	30,000
Later than one year and not later than five years	60,000	90,000
Later than five years	–	–
	90,000	120,000

In conclusion, more caution will be required when reviewing our business arrangements and accounting for leases under the requirements of FRS 102.

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