

FRS 102 IN PRACTICE: LEASES

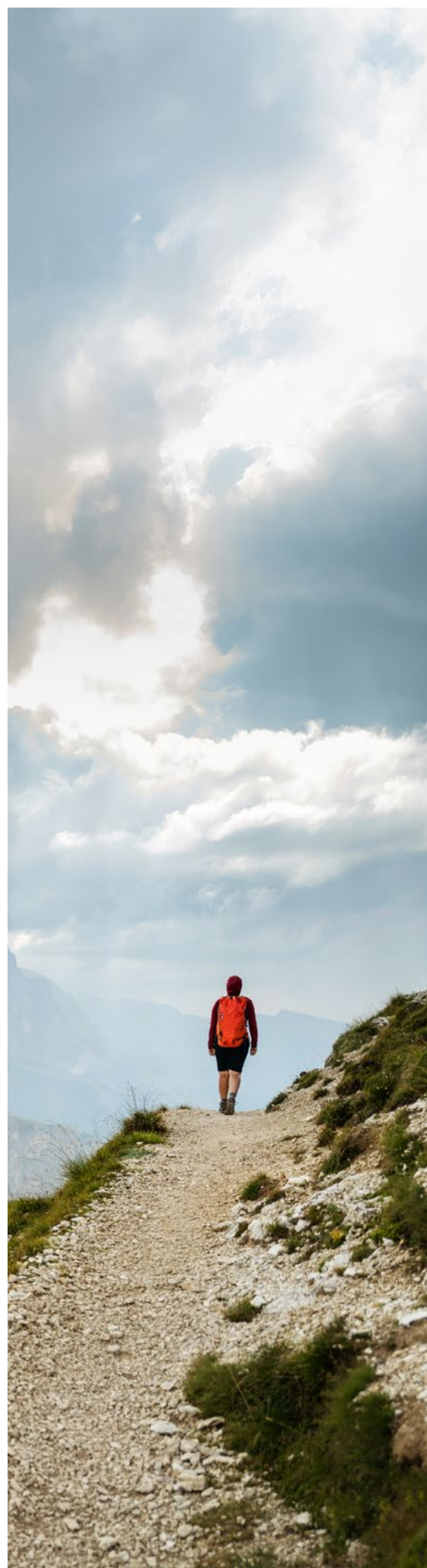


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1. Introduction

FRS 102 (September 2024), effective for annual reporting periods beginning on or after 1 January 2026, brought significant changes in accounting requirements for lease accounting, primarily for lessees.

This BDO *FRS 102 In Practice: Leases* sets out the requirements of FRS 102 (September 2024) in relation to the classification and measurement of leases, primarily from the perspective of lessees, with a brief overview of the requirements for lessor accounting.

In addition, this publication incorporates specific requirements for charities as set out in both FRS 102 (September 2024) and *Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland ("FRS 102 SORP 2026")*

The requirements in relation to classification and measurement of leases are summarised as below:

Lessees

Almost all leases are recognised in the statement of financial position as a 'right-of-use' asset and a lease liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low value and for short term leases (i.e. those with a lease term of 12 months or less). The asset is subsequently accounted for in accordance with the cost or revaluation model in Section 17 *Property, Plant and Equipment* or, if the right of use asset meets the definition of investment property, in accordance with the requirements of Section 16 *Investment Property*. The liability and right-of-use asset are unwound over the term of the lease giving rise to an interest expense and depreciation charge, respectively.

Lessors

Lessors need to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee. An exception is intermediate lessors, where the classification of the sublease is determined with reference to the intermediate lessor's right of use asset, and not the underlying asset.

In case of operating leases, the underlying assets continue to be recognised as assets in the statement of financial position and lease income is recognised on a straight line basis over the lease term (or as they fall due in a case where the lease payments are fixed but structured to increase in line with expected general inflation). For finance leases, a lessor is required to derecognise the underlying asset and record a receivable equal to the net investment in the lease, with a gain or loss on sale. Finance income is subsequently recognised at the interest rate implicit in the lease over the lease term.

2. Scope

The lease accounting model (as set out in Section 20 *Leases*) applies to contracts meeting the definition of a lease (see Chapter 3), except for:

▷ Section 3

- a. leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- b. leases of biological assets within the scope of Section 34 *Specialised Activities* held by a lessee;
- c. service concession arrangements within the scope of Section 34 *Specialised Activities*;
- d. licences of intellectual property granted by a lessor within the scope of Section 23 *Revenue from Contracts with Customers*;
- e. rights held by a lessee under licensing agreements within the scope of Section 18 *Intangible Assets other than Goodwill* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- f. leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms.

A lessee may, but is not required to, apply Section 20 *Leases* to leases of intangible assets other than those described in paragraph (e) above. A lessor does not have a choice and is required to apply Section 20 *Leases* to leases of intangible assets other than those explicitly excluded from the scope as set out above.

BDO comment – Company Cars

Where an entity provides its employees with the use of a car during their employment, then the arrangement may fall into the scope both of an employee benefit and a lease from the entity to the employee, depending on the particular facts and circumstances. There is no guidance in FRS 102 as to which of these takes precedence, although the accounting would be different in each case. Entities should apply judgement to determine which approach is most appropriate, using the guidance in FRS 102 Section 10 *Accounting Policies, Estimates and Errors* to develop an accounting policy. If it is to be considered an employee benefit, then the depreciation of the cars would be classified as a staff cost.

If the entity itself leased the cars from a third party, then the entity would need to consider whether it was acting as a principal or an agent (for its employees) in the arrangement, to determine whether it is a lessee for the vehicles under Section 20 *Leases*.



2.1 Recognition Exemptions

In addition to the above scope exclusions, a lessee can elect not to apply the recognition and measurement requirements of Section 20 *Leases* to:

- a. short-term leases; and
- b. leases for which the underlying asset is of low value ('low value leases').

The short-term lease exemption must be applied consistently to all underlying assets in the same class. The low value lease exemption, in contrast, may be applied on a lease-by-lease basis. See below for guidance on short-term leases and low value leases and Chapter 3 for identification of a lease.

If an entity applies either exemption, it must disclose that fact and certain information to make the effect of the exemption known to users of its financial statements (see section 7 – Disclosure). The lease payments associated with these leases shall be recognised as an expense on either a straight-line basis over the lease term or another systematic basis.

▷ Section 7

Short-term Leases

Short-term leases are defined as 'leases that, at the commencement date, have a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.'

BDO comment

This exemption simplifies the application of the standard for short-term leases significantly.

It is important to note that FRS 102's definition of 'lease term' must be considered carefully before concluding that a lease is a short-term lease. In particular, the lease term must consider the effect of options to extend or terminate a lease. This means that it will be unlikely to be possible to keep a lease off balance sheet by, say, structuring the contract with an initial term of 11 months and 29 days, with extension options for further periods of 11 months and 29 days, or by including periodic lessor termination options. This is because the 'lease term' as defined includes periods covered by extension options that are reasonably certain to be exercised by the lessee and the existence of termination options exercisable only by the lessor are disregarded.

Note that the definition of a short-term lease is based on the lease term at commencement date. This means that if a lease is initially assessed as not short-term, it cannot meet this definition later, unless there is a lease modification that qualifies for recognition as a new lease. For example, if a lease is for 9 months with a 6-month extension option that the entity assesses is reasonably certain to be taken, then the lease term is assessed to be 15 months which means it is not short-term. If the entity later decides that the extension option will not be taken, it cannot start applying the exemption.

However, FRS 102 20.8 states that if an entity is already applying the short-term lease exemption, then any lease modification or change in the lease term is treated as a new lease. This means that if an extension option is initially not included in the lease term but the entity later decided it was reasonably certain to be exercised, then the exemption would continue to be available only if the lease term for the new lease is assessed to be short-term.

Determining the lease term is discussed in more detail in Chapter 4 below.



Leases of Low Value Assets

The assessment of 'low value' for a leased asset is to be made on the basis of the value of the underlying asset (on an individual basis), and not the value of the lease payments. Additionally, the assessment is made regardless of whether the leased asset is material to the lessee. This guidance is meant to achieve the goal that different lessees should reach the same conclusions relating to underlying assets, regardless of their size, nature or circumstances.

An underlying asset in a lease can be of low value only if:

- a. the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and
- b. the underlying asset is not highly dependent on, or highly interrelated with, other assets.

This means that a lessee cannot claim that, for example, an aircraft or a vehicle are comprised of a large number of low value items (individual components) because, in the context of the overall operating asset, these components are highly dependent on and interrelated with each other.

If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low value asset.

Section 20 *Leases* provides examples of assets that are not low value, which include:

- ▶ 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; and
- ▶ Production line equipment.

The basis for conclusions also give examples of assets that would qualify as low value, which include tablets and personal computers, small items of office furniture and telephones.

BDO comment

The standard does not provide much guidance to assist in assessing what 'low value' means. Examples are provided to allow preparers to analogise the comparative cost of assets, but this may become problematic in the future as assets become more or less expensive due to technological advancement, which may increase the functionality of equipment and/or decrease its cost.

Unlike the Basis for Conclusions for IFRS 16, FRS 102 (including the Basis for Conclusions) does not contain any indication of amount that the FRC had in mind when drafting this exemption. There was a deliberate decision to insert a list of assets that would not qualify into FRS 102, rather than a list of assets that would qualify as for IFRS 16. The FRC expects that the exemption will more widely apply than the equivalent exemption in IFRS 16.

Other than assets that are specifically listed as not meeting the definition in FRS 102, the application of the exemption in FRS 102 is largely left to management judgement.

The exemption applies on an asset-by-asset basis. To illustrate, if an entity has a lease contract for 500 laptops, the exemption should be assessed based on the value of each laptop. The total value of the 500 laptops is irrelevant. Note that this assumes that the assets can be benefited from individually and are not highly dependent on or interrelated with each other.

The assessment of low value does not depend on the lessee's size and nature. This is illustrated in the following two examples.



Example 2.1-1 – Low Value Lease Assessment

Entity A is a large, multi-national technology company with approximately £10 billion in its annual operating budget. It enters into a contract to lease one floor of an office building in a major city in Central America for a total lease cost of £50,000 per annum for five years. The operations of the facility and the lease cost are immaterial to Entity A.

Assessment

Despite the fact that the lease is clearly immaterial to Entity A (it represents 0.0005% of the annual operating budget), a floor of an office building is not low value as set out in Section 20 *Leases*. Therefore, the lease does not meet the low value lease exemption.



Example 2.1-2 – Low Value Lease Assessment

A lessee in the pharmaceutical manufacturing and distribution industry has the following leases:

- ▶ Leases of real estate (both office buildings and warehouses);
- ▶ Leases of manufacturing equipment;
- ▶ Leases of company cars, both for sales personnel and senior management and of varying quality, specification and value;
- ▶ Leases of trucks and vans used for delivery purposes, of varying size and value;
- ▶ Leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones);
- ▶ Leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers;
- ▶ Leases of office equipment:
 - i. office furniture (such as chairs, desks and office partitions);
 - ii. water dispensers; and
 - iii. high-capacity multifunction photocopier devices.

Assessment

The lessee determines that the following leases qualify as leases of low value assets on the basis that the underlying assets are individually of low value:

- a. leases of IT equipment for use by individual employees; and
- b. leases of office equipment.

The lessee elects to account for these leases using the low value exemption.

Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low value assets. This is because each module is highly interrelated with other parts of the servers. The lessee would not lease the modules without also leasing the servers.

The remaining items are specifically excluded from the exemption in Section 20 *Leases*.

The high-capacity multifunction photocopier device is not specifically excluded from the exemption. This is an example of an asset that would probably not have qualified under IFRS 16 as its cost would exceed \$5,000 when new. FRS 102 preparers will need to exercise judgement in determining if such an item is of low value.

Peppercorn arrangements

Typically arrangements under which any public benefit entity (including charities) pays nil or only a nominal amount of consideration are known as peppercorn arrangements. FRS 102 states that arrangements where the contractual payments are so low that they are not substantive (such as peppercorn payments) may not meet the FRS 102 definition of a lease but are considered to be a form of non-exchange transaction.

In this scenario any nominal payments that are made are treated as an operating expense. Therefore such arrangements are outside the scope of Section 20 *Leases*.



3. Identifying a lease

As all leases (except for the limited exceptions described in Section 2) are recorded 'on balance sheet' by the lessee, a key consideration is whether a contract meets the definition of a lease in FRS 102:



A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time* in exchange for consideration.

*Note: a period of time may also be described in terms of an amount of use of an asset (e.g. number of production units that a piece of machinery will produce).

An entity only reassesses whether a contract is, or contains, a lease subsequent to initial recognition if the terms and conditions of the contract are changed.

Unit of Account

Section 20 *Leases* is written in the context of accounting for the lease of a single asset. This means

that the low value asset exemption described in section 2.1 above applies even if there is only a single lease contract for, say, 1,000 low value computers.

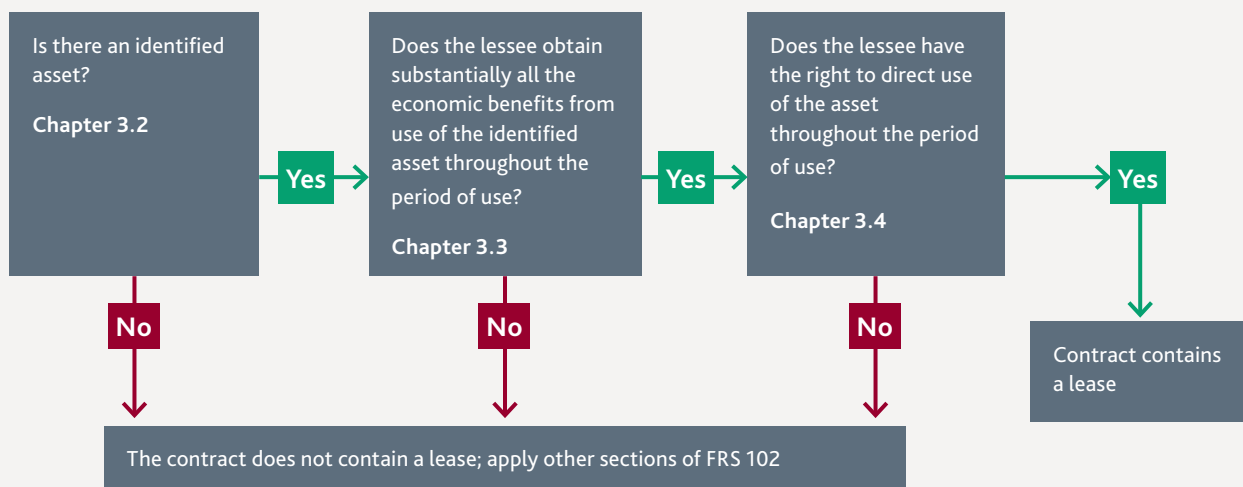
However, as a practical expedient to treating the unit of account as the lease of a single asset, an entity may apply Section 20 *Leases* to a portfolio of leases with similar characteristics.

If it accounts for the leases on a portfolio basis, an entity is then able to make estimates and assumptions that reflect the size and composition of the portfolio. Therefore, if an entity leases 1,000 vehicles under 1,000 separate contracts (i.e. each contract is for a single vehicle) it may be possible to consider the portfolio of leases as a single right to use 1,000 vehicles, rather than 1,000 rights to use a single vehicle. It will depend on how similar the features of each contract are (such as the specification of the vehicles), the extent to which they were entered into at or around the same time and how similar or dissimilar the lease term is.

3.1 Applying the Definition of a Lease

FRS 102 provides detailed guidance on the evaluation of a contract to determine whether it contains a lease.

In applying the definition of a lease, there are several criteria that must be met, as illustrated below:



3.2 Identified Asset

The first criterion to be assessed in determining whether a contract between a customer and a supplier contains a lease is whether there is an identified asset. This is consistent with the requirement that for a lease to exist, the customer must control the asset. Typically, an asset will be explicitly identified in a contract (for example, by specifying the registration or chassis number of a car as well as a description of the manufacturer and model). Alternatively, a contract can involve the use of an identified asset if that asset is implicitly identified at the point at which it is made available for use by the customer.

However, even if a contract specifies a particular asset, a customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset throughout the period of use.

Substitution Rights

A supplier's right to substitute an asset would be substantive, and therefore the customer would not account for a lease of that asset, if both of the following conditions are met:

- ▶ the supplier has the practical ability to substitute alternative assets throughout the period of use; and
- ▶ the supplier would benefit economically from the exercise of its right to substitute the asset.

BDO comment

It is important to note that both of the above criteria must be satisfied for a supplier's substitution right to be substantive. Some contracts contain clauses where a lessor has the right to substitute an asset. However, unless the lessor has a compelling reason to exercise this right, it is not substantive. In such a case, the substitution right may be protective (rather than substantive) to ensure the supplier's interest in the asset is maintained.

In addition, FRS 102 requires that this substitution right must exist 'throughout the period of use'. If a substitution right were to only be exercisable upon the occurrence of a specific event, after a period of time has elapsed or on a specific date, then the substitution rights would not be substantive for the purposes of FRS 102 as they are not present 'throughout the period of use'.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur. Following are some examples of events that at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include:

- ▶ an agreement by a future customer to pay an above market rate for use of the asset;
- ▶ the introduction of new technology that is not substantially developed at inception of the contract;
- ▶ a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and
- ▶ a substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract.

In situations where the asset is located at the lessee's premises or elsewhere away from the lessor, the cost to substitute the asset may outweigh any perceived benefit to the lessor. In addition, a supplier's right to substitute an asset for the purposes of repairs or maintenance (if the asset is not operating properly) or to be upgraded when a technical update becomes available, does not mean the lessor has a substantive right of substitution.

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive.

Since the standard requires lessees to conclude substitution rights are non-substantive where it is unclear, it should be assumed that the contract contains a lease in situations where there is doubt. Consequently, notwithstanding the existence of the substitution rights, if an asset is identified in the contract (by being explicitly or implicitly specified), further analysis of the contract is needed to see if the other two conditions of the definition of a lease are met (see sections 3.3 and 3.4 below).



Example 3.2-1 – Lease of Rail Cars

A contract between Customer and Supplier requires Supplier to transport a quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years. Supplier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of rail cars to fulfil each of Customer's requests, and a rail car could be used to transport not only Customer's goods, but also the goods of other customers. The cars are stored at Supplier's premises when not being used to transport goods.

Assessment

Supplier's substitution rights in this example are substantive because it:

- a. has the practical ability to substitute the rail cars throughout the period of use; and
- b. it would benefit economically from substituting the rail cars because there is a large pool of them available and they are stored at its premises. Potential benefits to Supplier are deploying the rail cars to a nearby location for use in other contracts or to use any of the 10 rail cars that are sitting idle for other purposes because they are not currently being used by Customer.

Therefore, although the contract makes use of identified assets (the rail cars), the contract does not contain a lease of those rail cars because Supplier has substantive substitution rights.



Example 3.2-2 – Lease of retail units

Entity A owns a retail space having multiple retail units. Entity B enters into a contract with Entity A to use Retail Unit 101 for a period of five years.

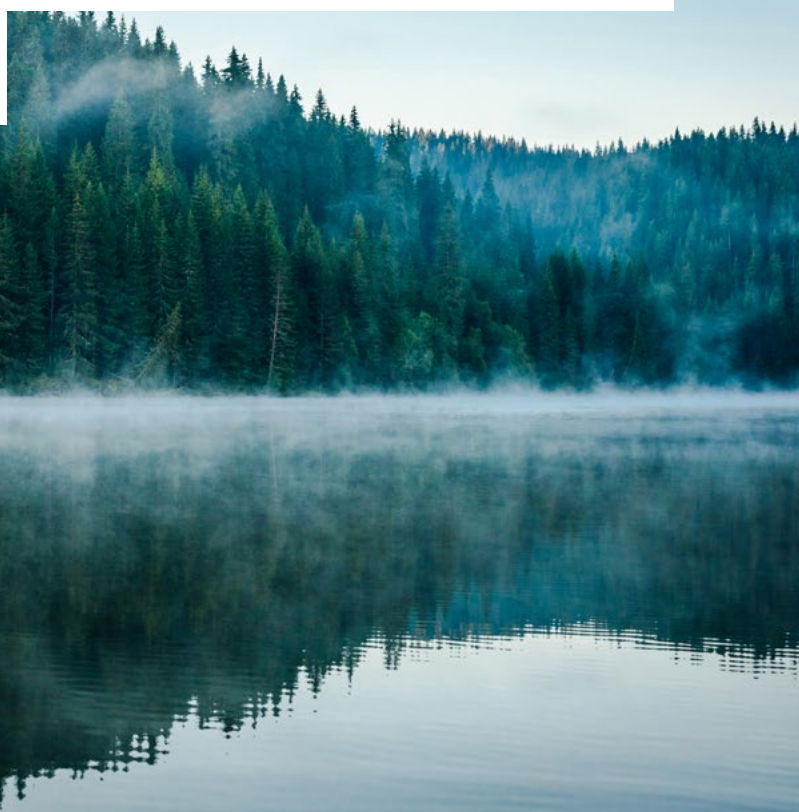
Entity A can require Entity B to relocate to another retail unit within the same premises. In that case, Entity A is required to provide Entity B with a retail unit of similar quality and specifications to Retail Unit 101 and to pay for Entity B's relocation costs. Entity A would benefit economically from relocating Entity B only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favourable to cover the costs of relocating Entity B and other tenants in the retail space. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

Assessment

Retail Unit 101 is an identified asset. Entity A has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Entity A's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise.

Portions of Assets

A capacity portion of an asset may be an identified asset if it is physically distinct (e.g. a floor of a building). A capacity portion of an asset that is not distinct (e.g. a specified capacity of fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset.





Example 3.2-3(a) – Fibre Optic Cable

A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong and Tokyo. The specified amount is equivalent to the customer having the full capacity of 3 fibre strands within a 15-strand cable. The supplier makes decisions about the transmission of data (i.e. which fibres are used to transmit the lessee's data).

Assessment

The contract does not contain a lease as the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset as the capacity is only 20% of the total capacity of the cable. If the contract specified an amount of capacity equivalent to, say, 14 fibre strands of the total cable, the contract would contain a lease because this represents substantially all (approximately 94%) of the cable's capacity.



Example 3.2-3(b) – Fibre Optic Cable (specific strands)

A customer enters into a 15-year contract with a supplier for the right to use 3 of 10 specific strands of fibre optic cable connecting Paris and London. The customer has the exclusive right to use these strands to transfer their data.

Assessment

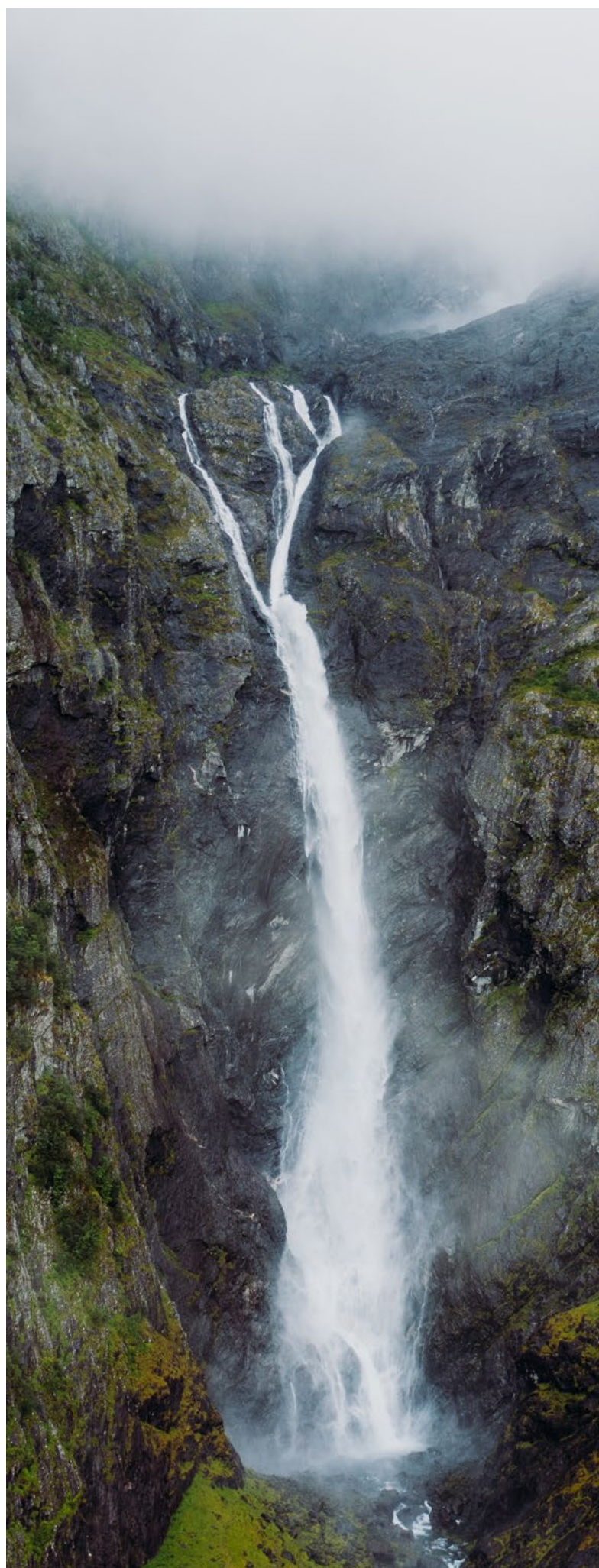
The contract does contain an identified asset as the strands of fibre optic cable are distinct from one another and the vendor does not have the right to substitute the strands for others in the same cable. Despite the number of strands not being substantially all of the cable's total capacity, the strands are identified, therefore the contract provides a specified asset to the customer.



BDO comment

The requirement that a portion of an asset can meet the identifiability criterion can be seen as a potential 'anti-avoidance' provision of the standard. Without this provision, a contract could exclude an insignificant portion of an asset's capability, and not meet the identifiability criterion.

Although FRS 102 makes reference to a capacity portion that is 'physically distinct', in our view this approach also applies when a capacity portion is technologically distinct. For example, a lease could be of all the light blue colour capacity of a fibre optic cable. In that case, the light blue component would be an identified asset for the purposes of FRS 102.



3.3 Obtaining Economic Benefits

The next criterion to analyse in determining if a customer controls the use of an identified asset is whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, for example by having exclusive use of the asset throughout the period of the contract or by having a right to sub-lease the asset.

Simply because lease payments include a portion of the cash flows derived from an asset (e.g. a percentage of sales from the operations of a property) does not mean that the customer does not obtain substantially all of the economic benefits associated with the asset. Such requirements are common in retail lease contracts.

Example 3.3-1 – Obtaining Economic Benefits with Outputs Flowing to Supplier

A retailer enters into a contract for the lease of a store in a shopping centre for five years. The rental terms include annual payments equal to 10% of the gross sales revenue generated from the store, payable at the end of the year. The retailer has the right to determine which products are to be sold, the interior design of the store, etc.

Assessment

It is the customer's control and use of the property which generates all of the sales revenue. The fact that a portion of the cash flows generated from use of the property are passed to the lessor is not relevant. The lessee has a right to 100% of the sales revenue generated from the store (i.e. all of the economic benefits generated by the store), albeit that it has negotiated a contract which results in rent being determined by reference to that gross sales revenue.

In assessing whether a customer has a right to substantially all the economic benefits from the use of an identified asset, the assessment should be made based on the asset's use within the defined scope of the contract. For example:

- ▶ If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory. It does not consider what economic benefits could be obtained had there not been any geographical restriction in the contract.
- ▶ If a contract specifies a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day. It does not consider what economic benefits could be obtained from using the machine twenty four hours a day.

Economic benefits from use of the asset include its primary outputs (e.g. finished goods for a manufacturer to sell) and by-products, including potential cash flows that are derived from these items. When considering economic benefits, emphasis should be placed on the benefits derived from using the asset rather than on other incidental benefits.

Example 3.3-2 – Obtaining Economic Benefits from use versus ownership of an asset

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The contract specifies that the energy must be produced from this particular facility (and so the supplier does not have substantive substitution rights). The supplier receives tax incentives from various levels of government for building the bio-mass facility, as it produces clean, renewable energy.

Assessment

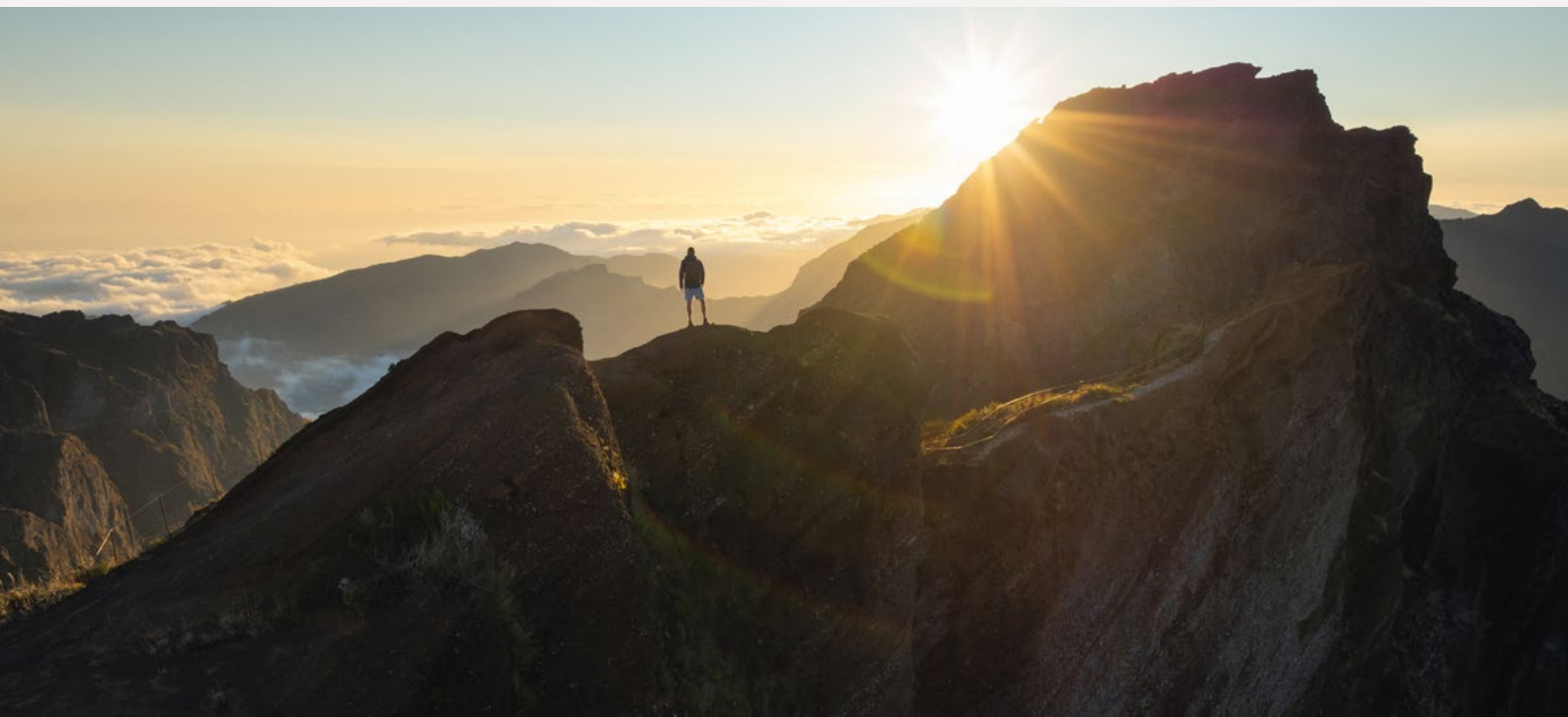
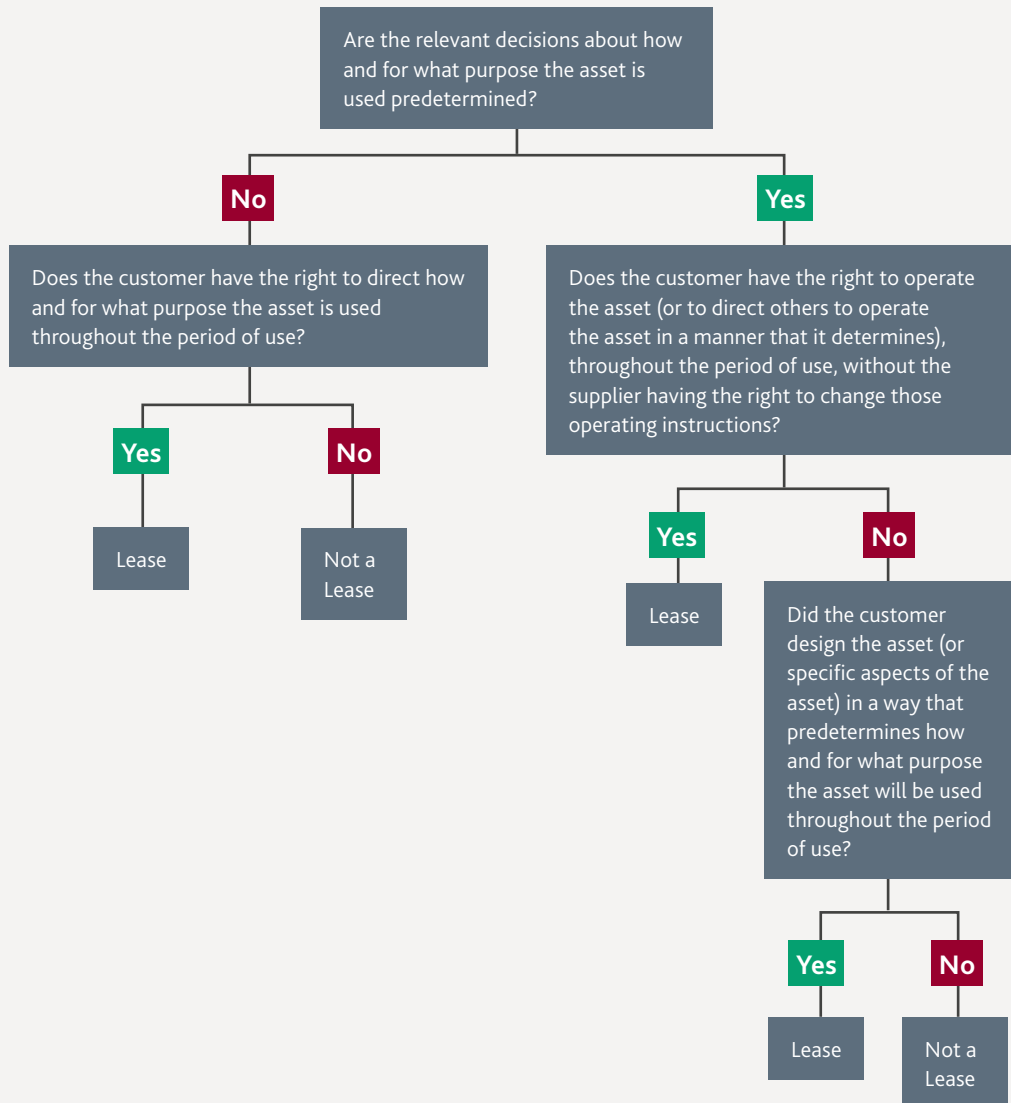
The contract transfers to the customer the right to obtain substantially all of the economic benefit from use of the underlying asset (the power plant) because the customer has exclusive use of the primary product of the facility (i.e. the electricity).

Although the supplier obtains economic benefits in the form of tax incentives, these derive from legal ownership of the asset, and not from its use. Therefore, the value of these tax incentives should be disregarded in assessing which party obtains substantially all the economic benefits of the bio-mass facility.



3.4 Right to Direct the Use of the Asset

In determining whether a customer has the right to direct the use of an asset, an analysis of whether the relevant decisions about how and for what purpose the asset is used are predetermined and who directs **how and for what purpose** the asset is used throughout the period of use needs to be carried out:



A customer has the right to direct how and for what purpose an asset is used if, within the scope of its right-of-use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. Certain decision making rights are clearly more relevant than others. Those that affect the economic benefits (or in the case of a charity, the ability to further the charity's objects) derived from use of the asset (as outlined in Chapter 3.3) are the most relevant.

Examples of decision-making rights that may grant a customer the right to change 'how and for what purpose' an asset is used (depending on the circumstances), include rights to change:

- ▶ the type of output that is produced by the asset (e.g. what type of food certain food processing equipment produces);
- ▶ when the output is produced (e.g. the regular operating hours for equipment);
- ▶ where the output is produced (e.g. the physical location of machinery or destinations and routes for transport equipment); and
- ▶ whether the output is produced, and the quantity of the output (e.g. to decide whether to produce energy from a power plant and how much energy to produce).

Decision-making rights relating to operating or maintaining an asset do not grant the right to change how and for what purpose the asset is used. However, the rights to operate an asset may grant a customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used is predetermined.

BDO comment

The guidance on determining who has the right to direct the use of the asset focuses on control. This is consistent with the FRC's focus on control being a primary element in determining whether transactions qualify for recognition in other parts of the standard, such as Section 9 Consolidated and Separate Financial Statements and Section 23 Revenue from Contracts with Customers.



Example 3.4-1 – Customer Directs Use

A customer enters into a five-year contract with a supplier where the customer will purchase up to 100% of the energy produced by a bio-mass facility. The energy must be produced from this particular facility and the supplier does not have substantive substitution rights to provide energy from a separate facility. Alternative arrangements can only be made in extraordinary circumstances (for example, emergency situations rendering the facility inoperative). Under the contract the customer tells the supplier how much energy to produce and when to produce it and the supplier must stand ready to operate the facility to meet the customer's needs. To the extent there is spare capacity, the supplier is not allowed to generate energy for sale to other customers. The supplier must therefore stand ready to provide all of the power output to the customer if needed. The supplier designed the facility when it was constructed some years before entering into the contract with the customer, who had no involvement in that original design.

Assessment

It is clear that the bio-mass facility is identified in the contract and the customer obtains substantially all of the economic output (it can take any amount up to 100% of the production capacity without anyone else being able to benefit from any spare capacity). The contract contains a lease for the bio mass facility because the customer also has the right to direct its use. That is, the customer makes the relevant decisions as to how and for what purpose the facility is used because it decides when and how much power is produced. The supplier's staff simply follow the directions of the customer. The fact that the customer had no involvement in the design of the underlying asset is only relevant when decisions about how and for what purpose the asset will be used are predetermined, as illustrated in example 3.4-3 below.

The customer therefore needs to determine how much of the total contractual payments to the supplier are for the leased asset as distinct from fees that may be charged for other services (such as operation and maintenance of the facility) and capitalise those lease payments on balance sheet. Alternatively, as a practical expedient, the customer can treat the entire contract as a lease, recognising an asset and liability for the present value of all payments to be made under the contract.



Example 3.4-2 – Charity sub-leasing

A charity whose objective is to support young people transitioning from the social care system leases a building and during the term of the lease the trustees decide to rent the space to a local youth group who will be running sessions on independent living for individuals aged 16-18.

Assessment

In this example the trustees of the charity decide on how the building will be used to further the charity's purposes and direct the activities that are carried out using the asset.

Therefore, the charity has the right to control the asset as it has the ability to further the charity's objects throughout the lease term.

The charity has the right to direct the use of an identified asset throughout the period of use only if either:

- ▶ the charity has the right to direct how and for what purpose the asset is used throughout the period of use, in a manner that affects the economic benefits derived from its use; or
- ▶ the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - the charity has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - the charity designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

3.4.3 Relevant Decisions are Pre-Determined

The nature of an asset or contractual restrictions may indicate that relevant decisions about how and for what purpose an asset will be used are pre-determined.

For an asset where the relevant decisions are pre-determined, the contract contains a lease if:

- a. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
- b. (The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.



BDO comment

Assets that may fall into this category include those that are:

- ▶ technologically advanced such that they are designed for highly specific purposes;
- ▶ costly to modify or repurpose for other uses; and/or
- ▶ whose use is restricted based on regulation or law.

An entity is only permitted to include in its analysis decision-making abilities that will arise during the term of the lease, except in the situation described in (b) above where the customer designed the asset. In such a situation, an entity would identify which elements were pre-determined by the decisions made prior to the asset being completed.

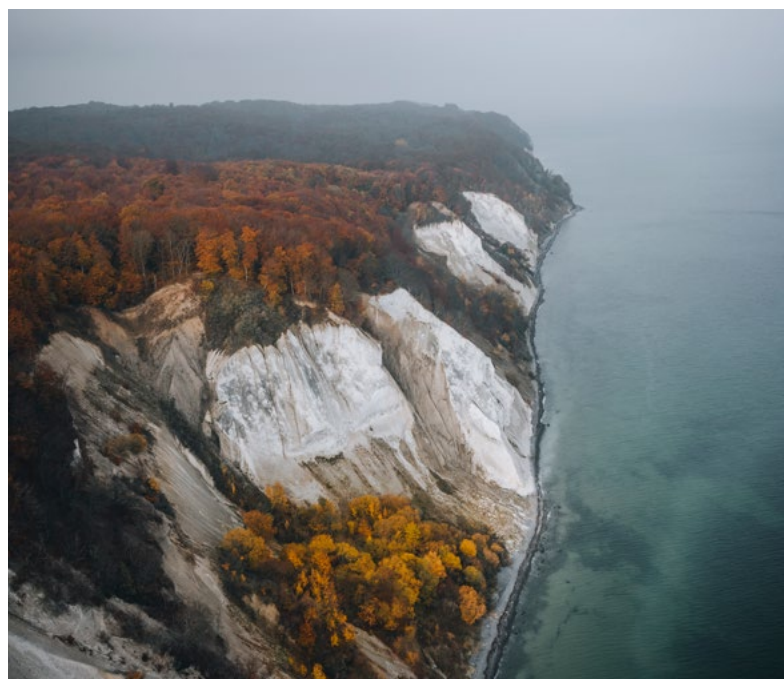


Example 3.4-3.1 – Pre-determined Functionality

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Assessment

In assessing the 'right to direct use of asset' criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer. Therefore, the customer has the right to direct its use.



3.5 Separation of Lease Components and combining contracts

Separation of Lease Components:

The right to use an underlying asset is a separate lease component if both:

- a. the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
- b. the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

For a contract that is, or contains, a lease component, an entity accounts for each lease component within the contract separately from non-lease components. However, a lessee may apply a practical expedient by class of underlying asset, and ignore the requirement to separate non-lease components (such as services) from the lease components. Instead it may account for the entire contract as a single lease contract. For example, a contract for the lease of an asset together with its maintenance during the lease term can be accounted for in its entirety as a lease contract rather than accounting for the lease of the asset separately from the maintenance service. This practical expedient is only available to lessees; it does not apply to lessors.

It should be noted that this practical expedient does not override the requirement to account for each lease component in a contract as a lease separately. For example, if a contract contains two lease components and a non-lease component, the lessee is not permitted to account for the entire contract as a single lease.

Allocation of consideration to components by a lessee

If the practical expedient to not separate lease and non-lease components is not used, a lessee must allocate the total contract consideration to each lease

component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components. The non-lease components are then accounted for applying other applicable sections of FRS 102.

The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If stand-alone prices are not available, then they must be estimated, maximising the use of observable information. This can be quite complex and judgemental and so applying the practical expedient simplifies the accounting. A consequence of using the practical expedient is that the amounts recognised on balance sheet are greater than would be the case from identifying the payments related to, and separately accounting for, the non-lease components. This is because by accounting for non-lease components as part of the lease component, those payments are included in the measurement of the lease liability and right-of-use asset.

BDO comment

Non-lease components exist in numerous types of lease agreements. For example, they may arise from maintenance included in the lease payments for vehicles, or common area maintenance costs for multi-unit real estate leases to cover shared costs such as security, cleaning, etc. In determining whether to elect to include non-lease components in the measurement of the lease contract, entities should consider the cost vs. benefit of determining stand-alone prices for the individual components.

Additionally, for non-lease components such as common area maintenance costs, entities should consider whether such costs are variable in nature and not dependent on an index or rate, and therefore would not be included in the lease measurement regardless of the accounting policy choice (see Chapter 5.1 for discussion of common area maintenance and variable lease payments).





Example 3.5-1 – Allocation of consideration between lease and non-lease components by a lessee

Entity A leases construction equipment from Entity B for a period of three years. The contract also provides for annual maintenance of the equipment and deployment of two personnel for operating the equipment.

Total consideration of the contract consists of the following:

1. £200,000 per year for three years
2. Annual maintenance charges of £20,000

Similar equipment is available on lease from Entity B for £150,000 per year, without annual maintenance and deployment of staff for operations.

Entity B also sells similar equipment and provides annual maintenance service for the equipment for £25,000.

Entity B does not deploy staff for operating the machines separately without leasing or selling the equipment. Staff of similar qualification and experience as those deployed by Entity B can be hired by Entity A for a monthly salary of £3,000.

Entity A elects not to use the practical expedient of not separating lease and non-lease components.

Assessment

The contract contains the following three components:

1. Lease component: Lease of the equipment
2. Non-lease component: Annual maintenance service
3. Non-lease component: Deployment of two personnel

The stand-alone prices of the above components are determined to be:

Component	(£)	Stand-alone price (£)
Lease of equipment (£150,000 * 3 years)		450,000
Non-lease components		
- Annual maintenance service (£25,000 * 3 years)	75,000	
- Deployment of two personnel (£3,000 * 2 personnel * 36 months)	216,000	
Total non-lease component		291,000
Total standalone price		741,000

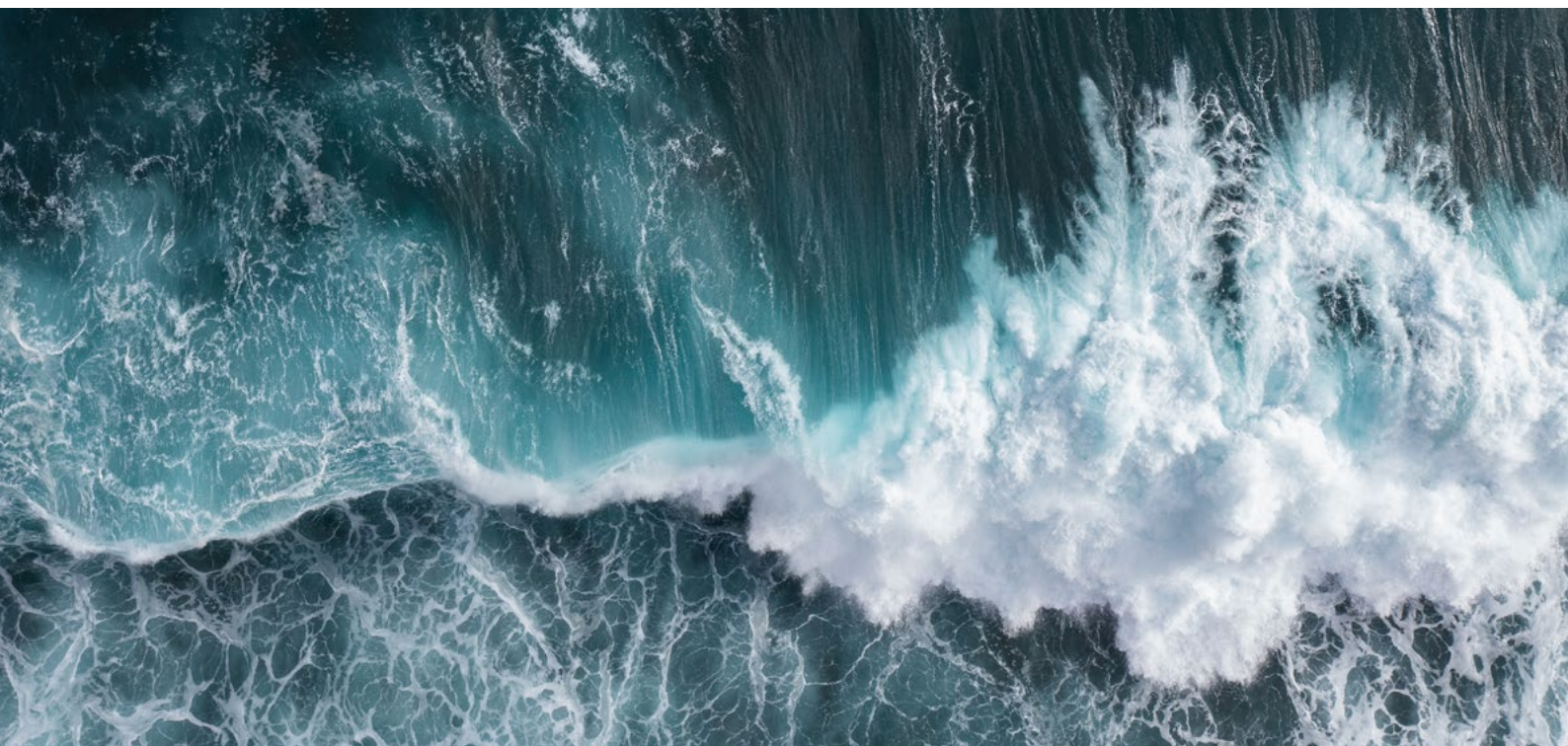
Total consideration for the contract is:

		Charges (£)
Lease charges (£200,000 * 3)	600,000	
Annual maintenance charges (£20,000 * 3)	60,000	
Total	660,000	



The total consideration will be allocated to the lease and non-lease components as below:

Component	Stand-alone price (£)	Ratio of stand-alone price	Allocation of consideration
Lease of equipment	450,000	60.7%	660,000 * 60.7% = 400,810
Non-lease components	291,000	39.3%	660,000 * 39.3% = 259,190
Total	741,000	100.0%	660,000



BDO comment

If the contract contains more than one component and has both variable and fixed payments, a question arises about the allocation of the variable consideration.

FRS 102 does not provide any specific requirements for allocation of variable consideration when a contract contains more than one component. In the absence of any specific requirements or guidance within FRS 102, Section 10 Accounting Policies, Estimates and Errors requires the management to develop and apply an accounting policy using its judgement. In making such judgements, FRS 102 requires the management to refer to and consider the applicability of the requirements in the standard dealing with similar and related issues. Section 23 Revenue from Contracts with Customers includes requirements on allocation of variable consideration to a performance obligation, which may be referred to for allocating variable consideration of components of a lease.

Section 23 Revenue from Contracts with Customers requires an entity to allocate variable consideration to all the performance obligations in the contract on a

stand-alone selling price basis, unless this basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. In that case, the entity shall allocate that discount or variable consideration using a method that reflects such an amount (eg a variable payment may be allocated entirely to one performance obligation in the contract if the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation).

The above requirements could be applied directly to lessors for allocation of variable payments in a lease contract.

In the absence of any specific requirements in FRS 102, a lessee may follow a similar approach for allocation of variable payments. Therefore, a variable payment would be allocated across all the components in the contract on the basis of relative stand-alone prices unless such a basis does not depict the amount of consideration for each performance obligation as detailed above.



Example 3.5-2 – Allocation of fixed and variable payments to multiple components

Entity A obtains an office space on lease from Entity B for a period of three years. Entity B also provides cleaning services.

The contract provides for following payments:

- a. Fixed payment of £100,000 per month
- b. Variable payment of £100 per hour of cleaning time. Total variable payment is estimated to be £6,000 per month. There is no minimum number of cleaning hours that must be purchased.

Entity B would charge the same fixed payment (£100,000 per month) towards rent of the premises even if cleaning services are not purchased by the lessee. Cleaning services are available from external agencies at an average monthly rate of £12,000.

Assessment

The contract consists of two components:

1. Lease component: Lease of office premises
2. Non-lease component: Cleaning services

Entity B provides office premises at the same rate as in the contract even if cleaning services are not purchased. Therefore, Entity A concludes that the fixed payment of £100,000 per month represents the stand-alone price of the lease component.

The estimated variable payment to be charged by Entity B (£6,000) for cleaning services is below the average monthly rate charged by external agencies. Therefore, Entity A concludes that the variable payment does not represent the stand-alone price of cleaning services. The stand-alone price of cleaning services is determined to be £12,000 per month.

Although the fixed payment represents the stand-alone price of the lease component, the variable payment does not represent the stand-alone price of the non-lease component. However, the variable consideration relates specifically to the entity's efforts to satisfy the cleaning services performance obligation. Therefore, allocating the variable consideration wholly to the cleaning service would be more appropriate than adopting a relative stand-alone selling price approach.

The lease component is therefore allocated £100,000 per month, and the non-lease component (cleaning) allocated £100 per hour of cleaning time.

Combining Contracts

It may be necessary to combine two or more contracts to assess whether the combined transaction constitutes a lease. For example, the substance of multiple legal agreements entered into at or near the same time with the same counterparty (or parties related to the counterparty) might only be understood when viewed as a single, composite contract. Combination of contracts is required if any one or more of the following criteria are met:

- a. the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together;
- b. the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- c. the rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component.



Example 3.5-3 – Identification of lease components and combining contracts

Entity C intends to lease a manufacturing facility, with fabrication machinery of certain specifications, in a particular location. Entity D owns a factory with required fabrication machinery in the location, which it intends to lease out.

Entity C leases the factory facility and fabrication machinery in the facility from Entity D. There are two separate contracts entered for the factory facility and the machinery. The contracts are executed a few days apart.

The contracts provide for the following payments:

1. Contract for lease of factory facility: Fixed payment of £60,000 per month
2. Contract for lease of machinery: Variable payment of £10 for each unit manufactured using the fabrication machinery. Estimated number of units manufactured per month is 10,000, resulting in an estimated variable payment of £100,000 per month.

A similar factory facility is available for rent, without the machinery, for a monthly payment of £80,000. Similar machines are available for a monthly payment of £75,000.

Assessment

Entity C evaluates the two contracts entered into a similar time to see if they meet the criteria to be combined into a single lease contract, as follows:

1. Condition (a): In this case, the contracts are negotiated as a package. They are executed near the same time with the same counterparty with an overall single commercial objective i.e. to obtain a complete manufacturing facility on rent.
2. Condition (b): A lower fixed payment as compared to market rates is agreed for the factory space with the expectation of making up the shortfall through variable payment estimated to be above market rate.
3. Condition (c): The contracts convey the right to use two underlying assets – the factory facility and the machinery.
 - The lessee is able to readily obtain on lease a factory facility and the machinery separately.
 - The factory facility and the machinery are not highly dependent on or highly interrelated with each other. The factory facility can be used for any other machinery. The machinery leased can be used in any other manufacturing unit.

Therefore, the two underlying assets are separate lease components.

Combination of contracts would be required if any one or more of the above criteria are met. As conditions (a) and (b) are fulfilled, the two contracts are considered as a single contract.

However, condition (c) is not fulfilled i.e. the rights to use underlying assets conveyed in the contracts do not form a single lease component.

Therefore, there is a single lease contract with two separate lease components - the factory facility and machinery. Accordingly, the total consideration (fixed and variable) is allocated to the two components based on relative stand-alone prices.



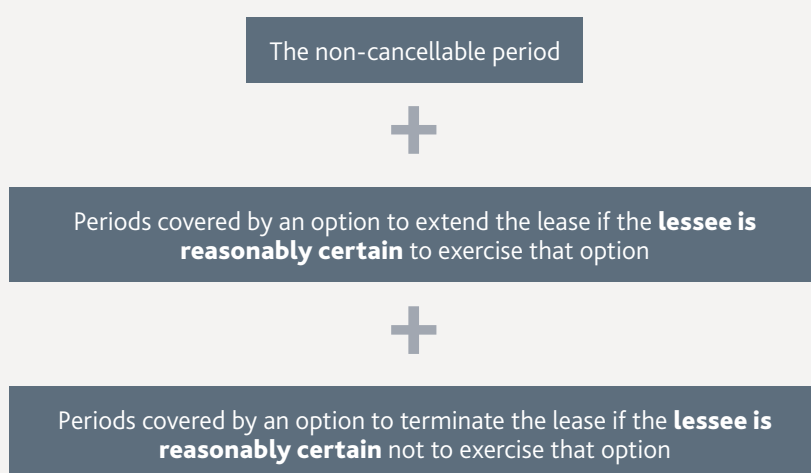
4. Determining the lease term

If a contract is, or contains, a lease, the lease term needs to be determined.

With the exception of the requirement to reassess whether an option is reasonably certain to be exercised, which applies only to lessees (refer to Chapter 4.2.1), the requirements of FRS 102 regarding determination of lease term apply to both lessees and lessors.

The lease term begins on the commencement date (i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods.

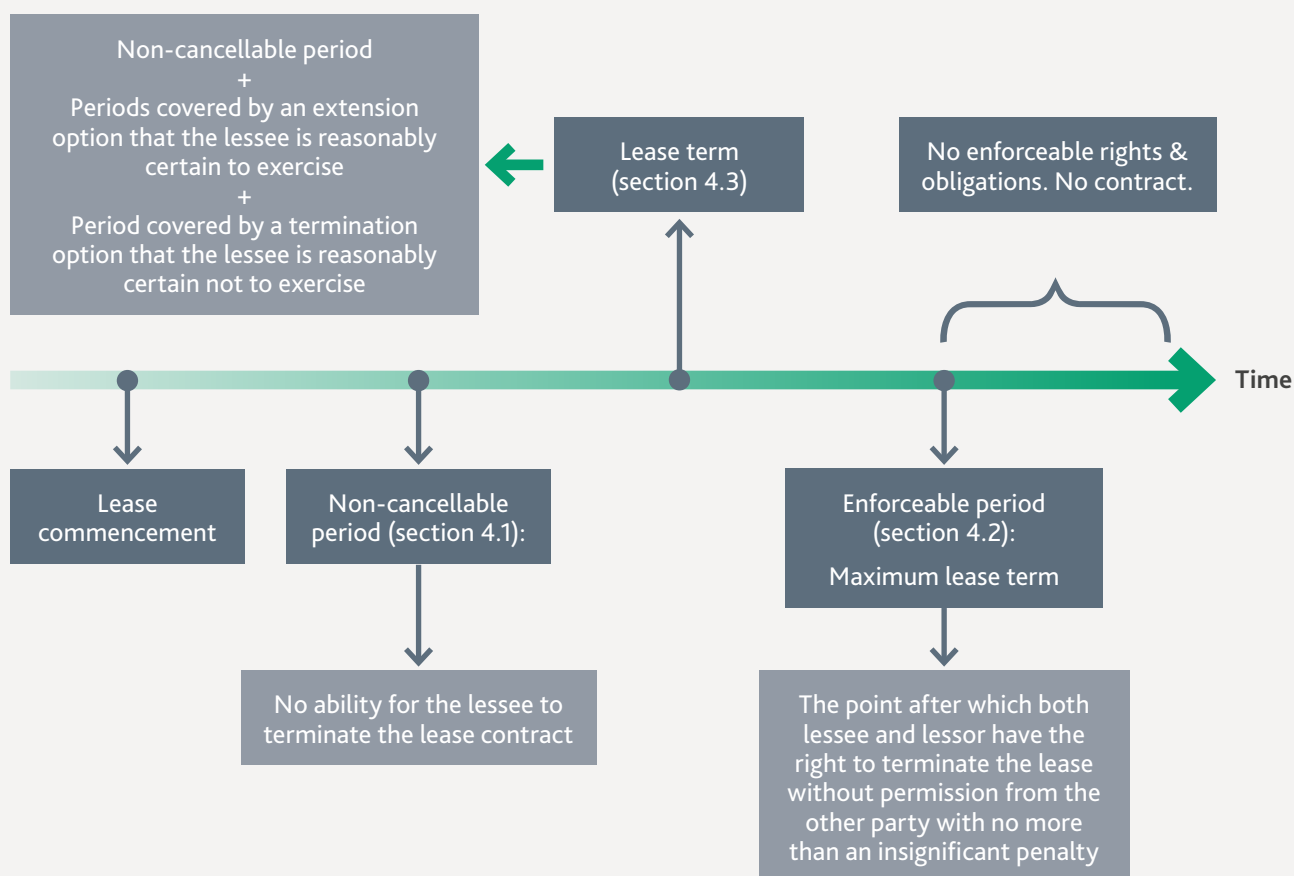
It comprises (emphasis added):



See Appendix B for a flowchart that may assist entities in applying the requirements of FRS 102 in determining the lease term. The flowchart summarises the guidance noted below, including assessing the period of time over which a lease remains enforceable.

There are three periods which need to be considered when determining the lease term in accordance with FRS 102 – the non-cancellable period, the enforceable period and the lease term, as depicted in the following diagram.





The following sections discuss how these periods are determined, along with illustrative examples and a summary of the methodology that should be applied in determining the lease term.

IFRS 16.B34 requires the following with respect to determination of lease term:

IFRS 16.B34 (emphasis added)

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

4.1 Non-cancellable period

This is the period during which the lessee is unable to terminate the contract.

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term.

If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease. In these cases, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. For example, Entity A leases office space for a period of 5 years from Entity B. The contract provides Entity B with the right to terminate the lease after 2 years. Entity A does not have such termination option.

In this case, the termination option available only to the lessor, i.e. Entity B, is disregarded for the purpose of determining the non-cancellable period as Entity A has an unconditional obligation to pay for the right to use the asset for the period of 5 years, unless and until Entity B decides to terminate the lease. Therefore, the non-cancellable period is determined to be 5 years.

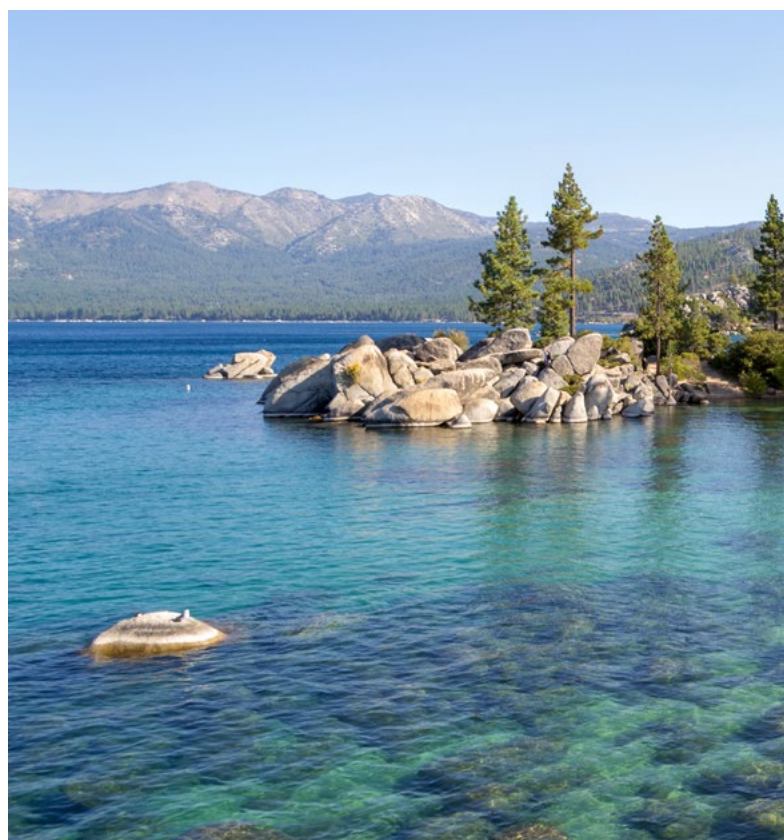
The non-cancellable period establishes the minimum lease term.

4.2 The enforceable period

This is the period for which enforceable rights and obligations exist between the lessee and lessor. A lease is no longer enforceable at the point at which 'the lessee and lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty'. This means that both the lessee and the lessor have to satisfy this condition.

The enforceable period establishes a maximum lease term.

The effect of lessee and lessor termination rights on the enforceable period is summarised below:



	Lessee does not have the right to terminate the lease without permission from the lessor with no more than an insignificant penalty	Lessee has the right to terminate the lease without permission from the lessor with no more than an insignificant penalty
Lessor does not have the right to terminate the lease without permission from the lessee with no more than an insignificant penalty	Lease considered enforceable	Lease considered enforceable
Lessor has the right to terminate the lease without permission from the lessee with no more than an insignificant penalty	Lease considered enforceable	Lease not considered enforceable

Assessment of a more than an insignificant penalty

Entities should consider all factors relevant to both the lessee and lessor in determining whether a more than an insignificant penalty exists, which may include other economic consequences (e.g. moving costs, loss of the use of a key location, and the cost of the current lease in comparison to current market rates). Thus, a lessee is required to consider factors relevant to both the lessee and lessor and a lessor is required to consider factors relevant to both the lessee and the lessor in determining whether a more than an insignificant penalty exists. This assessment may involve significant judgement.

Consider a situation where a lease contract is entered for a period of 10 years with a non-cancellable period of five years. After the end of the non-cancellable period, both lessee and lessor have a right to terminate the lease with a notice period of one month. The lessee has installed significant leasehold improvements that have a useful life of 10 years. In this case, termination of the lease soon after five years could result in a more than insignificant penalty for the lessee, but not for the lessor.

It might be argued that the lease is not enforceable after five years because the lessor could terminate the lease at any point after five years as the lessor would not incur a more than insignificant penalty on termination.

However, FRS 102 requires that in determining the enforceable period, an entity that is party to a lease contract must identify the point at which both it and the counterparty have a right to terminate the lease without permission from the other party and, if so, whether the termination would result in a more than insignificant penalty for the party exercising its right. As long as a more than insignificant penalty exists for either party on the exercise of its right to terminate the lease, the contract is enforceable for the purposes of the accounting requirements of FRS 102.

In this case, as a more than insignificant penalty exists for the lessee for termination before 10 years due to significant leasehold improvements, the contract is considered enforceable even after five years.

4.2.1 Lessee Extension and Termination Options

Once the non-cancellable period and the enforceable period have been determined, the next step is the determination of the lease term. Determining the lease term requires an assessment of options that may exist within lease contracts.

Options to extend or terminate a lease contract are common in many types of leases.

The lease term includes any 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.

At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity is required to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

Factors that would be considered in this assessment include, but are not limited to:

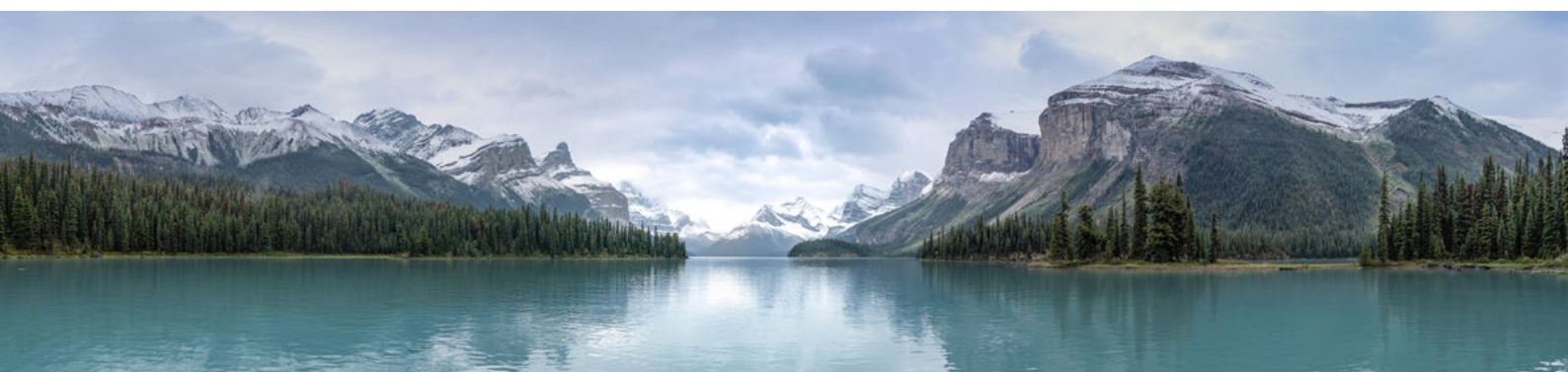
- a. Contractual terms and conditions for the optional periods compared with market rates, such as:
 - i. the amount of payments for the lease in any optional period;

- ii. the amount of any variable payments for the lease or other contingent payments;
 - iii. the terms and conditions of any options that are exercisable after periods covered by another option (or other options), e.g. a purchase option that is exercisable at the end of one or more extension periods at a rate that is currently below market rates.
- b. Significant leasehold improvements or other improvements made to underlying assets that are expected to have a significant residual benefit to the lessee when options become exercisable;
 - c. Costs relating to the termination of the lease (e.g. negotiation, relocation, and search costs, installation and setup costs for new assets, termination penalties or costs to return an underlying asset at the end of the lease term);
 - d. The importance of an underlying asset to the lessee's operations (e.g. whether the underlying asset is highly specialised, the location of the asset and the availability of suitable alternatives); and
 - e. Conditionality associated with the exercise option (i.e. if an option can be exercised only if one or more conditions are met) and the likelihood that those conditions will be met.

A lessee's past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease, as the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period is.

The reason for exercising such options may not be apparent from any single criterion, but may relate to synergies and a weighting of several reasons that must be considered in aggregate. Therefore, two lessees may determine different lease terms on identical lease contracts because the facts and circumstances under which they operate may mean that one lessee concludes it is reasonably certain to exercise one or more options, whereas the other might conclude it is not reasonably certain any of them will be exercised.



4.2.1.1 Termination option held by only the lessee or only the lessor

Some lease contracts provide a termination option to only the lessee or only the lessor. FRS 102 20.38 requires the following with respect to the determination of the lease term in such cases:

FRS 102 20.38(c) (emphasis added)

An entity shall **determine the lease term as the aggregate of...periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.** If **only a lessee** has the right to terminate a lease, that right is considered to be an **option to terminate** the lease available to the lessee that an entity considers when determining the lease term. **If only the lessor has the right** to terminate a lease, **the non-cancellable period of the lease includes the period covered by the lessor's option to terminate** the lease.

A lessee's right to extend or terminate the lease provides enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. This is the fundamental reason why lessee and lessor termination options are treated differently for purposes of determining the lease term.

BDO comment

Requiring a lessee to estimate the likelihood of the lessor exercising termination options (or not exercising extension options) would have necessitated making significant judgements about the intentions and economic conditions of lessors, for which the lessee will often have only limited information. A lessee also has an unconditional obligation to pay for the right-of-use asset during periods covered by lessor extension and termination options, unless and until the lessor decides to terminate the lease. Therefore, FRS 102 requires a lessee to assume that a lessor will continue to enforce a contract over the period of time during which the lessor has the sole, unilateral right to terminate the contract. This is the case even if the lessee believes it is highly likely that the lessor will exercise a termination option. This is because the exercising of the lessor's option to terminate is outside of the lessee's control, meaning that the lease payments meet the definition of liabilities because the lessee can be compelled to continue making payments to the lessor.

Example 4.2.1.1-1 – Assessment of Lease Term (only lessee has termination option)

A customer is considering entering into a lease for equipment to manufacture widgets.

The lease has a five-year term, with an option exercisable by the lessee only to extend the lease for an additional two years. This means that there is effectively a termination option for the lessee at the end of year five, but not for the lessor. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional two-year period if the lessee exercises its extension option.

The customer operates in a remote location where the cost of shipping and installation for pieces of equipment is significant.



Assessment

Only the lessee can terminate the lease which means that the enforceable period is seven years. The customer lacks a direct, contract-specific economic incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease. However, all relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered. This, therefore, includes entity-specific factors such as the costs the customer would incur to obtain a suitable replacement asset, the importance of the asset to the customer's operations, and the availability of suitable replacement assets. As the customer operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement, it concludes that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be seven years.

Example 4.2.1.1-2 – Assessment of Lease Term (both lessee and lessor have termination option)

Assume similar facts to the prior example except both the lessee and the lessor have a termination option at the end of year five with a zero termination payment, which can be exercised without permission from the other party.

Assessment

Since both the lessee and lessor have a termination option which is exercisable without permission from the other party, it is necessary to determine if there is no more than an insignificant penalty. This assessment determines whether the lease is enforceable beyond the non-cancellable five-year period.

The contract specifies there is no monetary penalty; however, this is only one kind of penalty that could arise. There needs to be no more than an insignificant penalty of any type for either party in order for the termination clause to have economic substance and the lease term to be enforceable for only five years. There could be other kinds of economic penalties in addition to those explicitly in the contract. In this instance, due to the remote location and likely difficulty in obtaining a new tenant, the lessor would have an economic penalty. In addition, as noted in example 4.2.1.1-1, the lessee would also have economic penalties because it operates in a remote location, which inherently increases the cost of not extending a lease for a key

piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement. Therefore, the penalty is determined to be more than insignificant and the contract is enforceable.

The term of the lease is then determined based on the lessee factors similar to example 4.2.1.1-1 with the conclusion that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be seven years. Therefore, it is important to note that a lease contract containing a mutual termination option does not automatically limit the lease term to the period up to the point at which the mutual termination option is exercisable.

Example 4.2.1.1-3 – Assessment of Lease Term (only lessor has termination option)

Entity A, the lessee, enters into a lease of office space with Entity B, the lessor, for a period of five years. The agreement provides a right to Entity B to terminate the lease at the end of three years, with a 90 day notice period. Entity A does not have a right to terminate the lease before five years.

Assessment

As only the lessor has the right to terminate the lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease. Therefore, the non-cancellable period of the lease is five years.

Useful life of leasehold improvements

A question arises as to whether the useful life of non-removable leasehold improvements is limited by the lease term of the associated lease. For example, if an entity installs non-removable leasehold improvements that would normally have a useful life of 10 years, but the underlying lease term, as determined by FRS 102, is only five years, would the useful life of the leasehold improvements be limited to the five year lease term?

FRS 102 17.21(d) specifies that in determining the useful life of an asset, an entity considers any legal or similar limits on the use of the asset, such as expiry dates of related leases. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease then it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term.

4.3 The lease term

The lease term is the non-cancellable period of a lease plus any 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. The lease term is between a minimum of the non-cancellable period and a maximum of the end of the enforceable period.

BDO comment

When determining the lease term, **both the lessee and the lessor** assess the reasonable certainty of the lessee exercising an extension option or not exercising a termination option.

Thus, the lessor also assesses whether the **lessee and not the lessor** is reasonably certain to exercise an extension option or not to exercise a termination option.

Reasonable certainty vs. more than an insignificant penalty

The assessment threshold for the determination of lease term is 'reasonable certainty' i.e. whether the lessee is

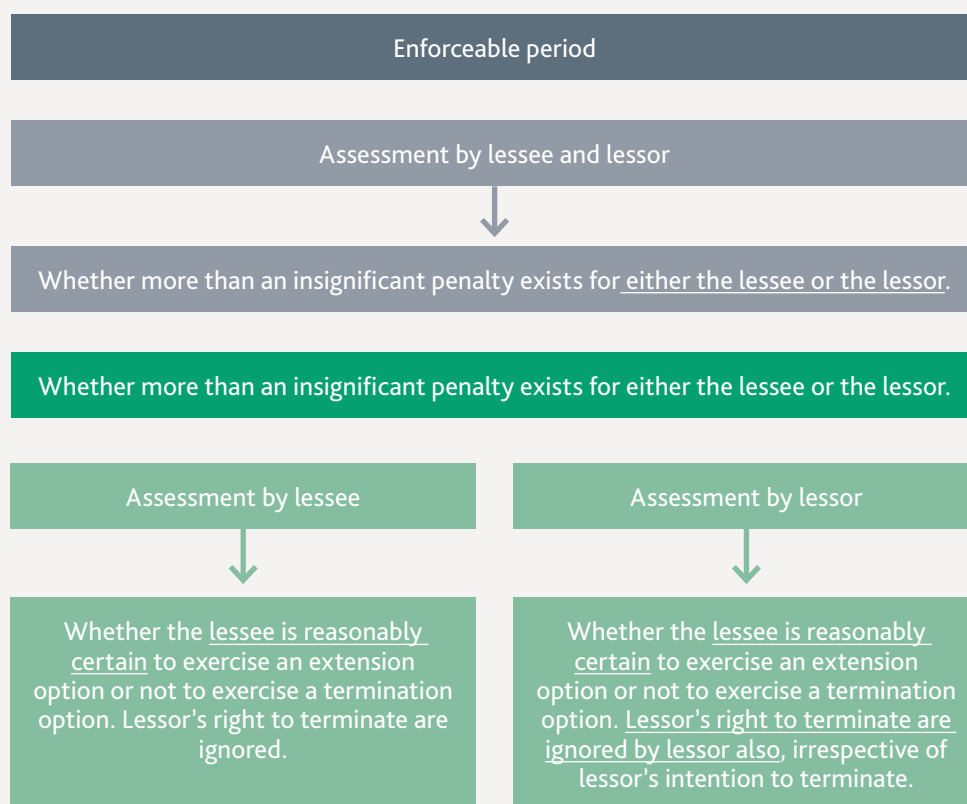
reasonably certain to exercise or not to exercise an extension or termination option. Whereas, for the determination of the enforceable period, the assessment refers to a 'more than an insignificant penalty'. Generally, 'reasonable certainty' may be considered a higher threshold than a 'more than insignificant penalty', meaning that the lease term may be shorter than the enforceable period. For example, a lessee may not be reasonably certain to exercise an extension option despite the period covered by the extension option being part of the enforceable period of the lease.

Assessment of enforceable period vs. lease term by a lessee and a lessor

When assessing the enforceable period, both lessee and lessor assess whether there is a more than an insignificant penalty for **either the lessee or the lessor** to exercise a termination option.

When assessing the lease term, both lessee and lessor assess whether **the lessee** is reasonably certain to exercise an extension option or not to exercise a termination option.

The following diagram summarises these requirements:



4.4 Lease term – Common application issues

Notice period

Notice periods in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. For example, a lessee and a lessor enter into a contract for use of premises for a period of four years, with a non-cancellable period of two years. After two years, both the lessee and the lessor have a right to terminate the lease with three-months notice. Assuming neither the lessee, nor the lessor will suffer a more than an insignificant penalty on termination, the lease term would be two years and three months.

Rent-free period

Many lease agreements provide for a rent-free period, usually at the beginning of the contract. The lease term includes any rent-free periods provided to the lessee by the lessor. Assuming a lease contains fixed lease payments, the lease liability would accrete during this rent-free period, resulting in the recognition of finance expense (see Chapter 5.4) and the right-of-use asset would be amortised (see Chapter 5.4).

Clause providing for 'first look' to the lessee for renewal

Some lease agreements contain a fixed, non-cancellable period followed by a period for which the lessee and the lessor may (but are not obliged in any way to) extend the lease if they agree to new terms and conditions (i.e. a 'first look' to the lessee before entering into a contract with any other party). This is an invitation to enter into a new contract (provided there are no other factors such as local laws giving rise to rights and obligations resulting in a longer lease term), and not an arrangement that could result in an extension of the existing, original contract.

Instances where the non-cancellable period, enforceable period and lease term are the same

There may be situations where the non-cancellable period, enforceable period and the lease term are the same. For example, if the contract provides for a non-cancellable period of five years and no other provisions exist that could extend that period beyond that date (that is, the only way to extend the lease would be to enter into a new contract), then the non-cancellable period, enforceable period and lease term are all five years.

Similarly, a contract might contain a fixed, non-cancellable period with there being no other factors (such as local laws) that could give rise to a longer lease term. At the end of the fixed period, the lessee could voluntarily continue to use the leased asset and pay monthly amounts to the lessor, and the lessor might accept this arrangement. In this scenario, the two

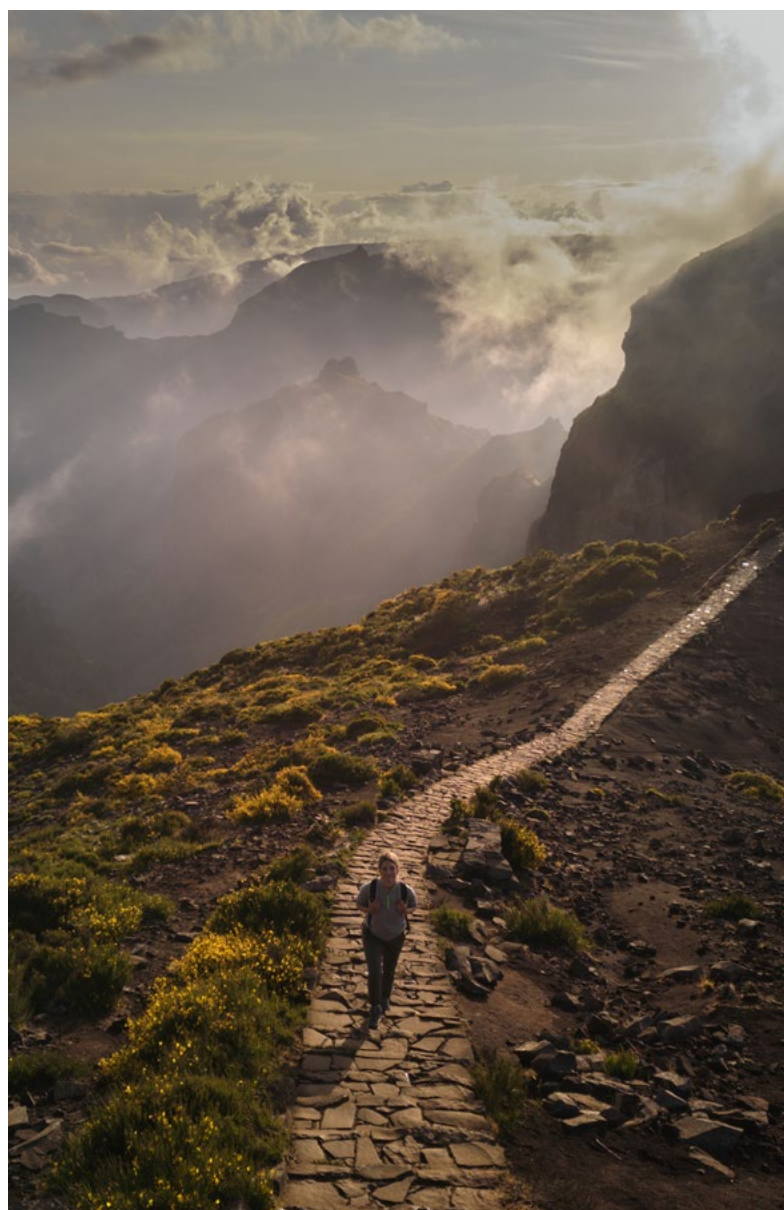
parties have voluntarily chosen to continue an expired lease on a 'month to month' basis. As a result, after the original contract expires, the lease term is one month and resets each month thereafter. This differs from a situation where local laws provide that a contract will automatically convert into a 'month to month' lease after the non-cancellable period expires or 'rolling leases' (see example 4.4-3) discussed below.

Effect of rights and obligations arising from law, statute or common law

FRS 102 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations.

The enforceable rights and obligations may arise directly from the contractual terms of the agreement or from the underlying legal framework (which can include statute and common law).

Many jurisdictions have legislation and/or common law that provides lessees and lessors with rights and obligations beyond those that are explicit in the documented lease contract, which entities must consider while determining the lease term





Example 4.4-1 – Effect of rights and obligations arising from law on determination of lease term

Scenario 1:

Entity A, the lessee, enters into a lease contract with Entity B, the lessor, for use of premises for a period of five years. The lease agreement grants Entity A the right to remain in the leased premises subsequent to the five-year fixed period as long as Entity A continues to make lease payments, which become indexed to CPI after the fixed period.

Scenario 2:

Entity C, the lessee, enters into a lease contract with Entity D, the lessor, for use of premises for a period of five years. The lease agreement does not contain any provision granting the right to Entity C to remain in the leased premises after the period of five years. However, local laws grant the lessee the right to remain in the leased premises as long as they continue to make lease payments, which become indexed to CPI after the fixed period.

Assessment

While the two lease contracts in the above scenarios differ in their strict contractual terms, the rights and obligations of the lessee and lessor are identical in both scenarios because the lessee is granted rights by the local legal framework in the second scenario rather than the documented lease contract. Therefore, in determining the lease term, both contracts are in-substance identical.

Note that in the UK, the Landlord and Tenant Act 1954 grants a statutory right to a new tenancy in some circumstances once the current lease expires. Entities with rights under the Act will need to give careful consideration to what period the lease is enforceable. Where material, entities should disclose accounting policies addressing such situations along with relevant information concerning any key judgements.

Entities should consider whether occupation of a property in relation to a lease that has expired constitutes a lease (for example, whether the Landlord and Tenant Act means there is an enforceable contract), for what period the lease is enforceable, and what the non-cancellable period of the lease is. This is likely to be a judgemental area.

Cancellable leases, renewable leases, rolling leases

Some leases do not have a fixed lease term and continue until one of the parties terminate the lease, usually requiring a short notice period or they renew automatically on a periodic basis such as day-to-day, week-to-week, month-to-month. These are often referred to as rolling leases.

When determining the lease term for a cancellable or renewable lease, an entity considers the broader economics of the contract, and not only contractual termination payments and whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Therefore, the enforceable period and/or the lease term of the lease may extend beyond the non-cancellable period into the 'rolling' period when the lease renews automatically until one of the parties terminates.



Example 4.4-2 – Determination of lease term for cancellable leases

Entity A leases a machine from Entity B for a construction project. There is no contractual term specified in the agreement. Both entities have a right to terminate the lease at any time by giving one month's notice to the other party. The machine leased is specifically identified in the contract. Entity B's right to substitute is not considered substantive.

The project is expected to take two years for completion and the machine is required for the entire duration of the project.

Entity A has concluded that the contract contains a lease.

Assessment

The non-cancellable period of the lease is one month, which is the notice period. Neither the lessee nor the lessor will be able to terminate the lease before one month.

The enforceable period of the lease may be longer than one month. Although Entity A does not have any contractual obligation to continue using the machine leased from Entity B for the entire project duration, the costs for Entity A to terminate this lease and enter into a new lease (e.g. finding a new supplier, legal costs, interruption in the construction project, additional transportations/ deployment costs) may result in a more than an insignificant penalty for Entity A. In that scenario, the enforceable period of the contract may be up to two years. As the machine is required for the entire duration of the project, the lease term may also be two years depending on the particular facts and circumstances.



Example 4.4-3 – Determination of lease term for rolling leases

Entity A enters into a lease of office premises from Entity B. The contract is for an initial period of one month. The contract provides for automatic renewal of the lease at the end of the month for another period of one month, unless terminated by either the lessee or the lessor (i.e. the lease is a month-to-month lease).

Entity A concludes that the contract contains a lease.

The location is suitable for Entity A's business and premises of similar size are not readily available in the vicinity. Entity A expects a substantial increase in the number of employees at the end of two years, which would necessitate relocation to larger office premises.

Entity B would not incur a more than an insignificant penalty on termination of the lease at any point.

Assessment

The non-cancellable period of the lease is one month, which is the initial period of the contract during which neither the lessee nor the lessor can terminate the lease.

The enforceable period of the lease is longer than one month. As the location is suitable for Entity A's business and premises of similar size are not readily available in the vicinity, there is a compelling economic reason for Entity A to continue with the same premises for two years, after which it anticipates that it will need to move to larger premises. This economic reason would result in a more than an insignificant penalty for Entity A to terminate the lease before two years. Therefore, the enforceable period of the lease would be two years.

Based on the particular facts and circumstances, Entity A determines that it is reasonably certain not to terminate the lease before two years. Therefore, the lease term is two years.

If, in the above example, similar office premises were readily available in the vicinity, the assessment of lease term may change. In this case, there may not be a compelling economic reason and there may not be a more than an insignificant penalty for Entity A to terminate the lease before two years. Therefore, the lease term would be one month. In such a case, Entity A would be eligible for the short-term lease exemption.

Thus, it should be noted that rolling leases may not always qualify for the short-term lease exemption. The lessee is first required to assess the lease term at commencement and if it is less than 12 months, the lease would qualify for short-term lease exemption.

Lessor's right to refuse an extension request

Some leases contain a clause that provides that the lessee may request a renewal of the lease, subject to the lessor's agreement.

In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease.

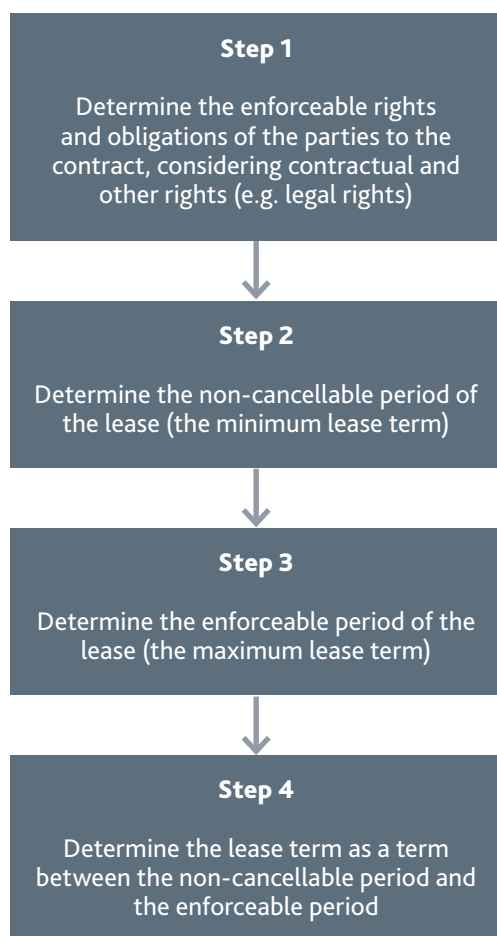
A question arises whether the lessor's right to refuse a request from the lessee to extend the lease prevents the contract from being enforceable. The lessee's option not to request a renewal and the lessor's option to refuse a renewal are substantially equivalent to termination options. The term 'enforceable' is not defined in FRS 102. However, in the context of FRS 102 Section 20 Leases, 'enforceable' is not strictly a legal concept. As required by FRS 102 20.39,

... A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

Therefore, in cases where the contract provides for an extension subject to the lessee requesting an extension and the lessor agreeing, for purposes of determining the enforceable period, the entity needs to assess whether the lessee or the lessor would suffer a more than an insignificant penalty. For example, a lease contract provides the lessee with a right to request an extension to the lease and the lessor with a right to refuse the extension request from the lessee. If neither the lessee nor the lessor is expected to suffer a more than an insignificant penalty by not extending the contract (which is in substance a termination option), the extension period will not be included in the enforceable period. However, if the lessee is expected to suffer a more than an insignificant penalty by not extending the lease, the enforceable period will include the extension period. A lessor's right to refuse an extension request, by itself, cannot be considered to prevent the contract from being enforceable for the purpose of accounting in accordance with FRS 102 (see Chapter 4.2). Note that the lease term may or may not include the periods covered by the extension option, depending on the assessment of the options (see Chapter 4.2).

4.5 Determination of lease term – examples

In summary, in determining the lease term, entities are required to consider the following:



Example 4.5-1 – Determination of lease term: Non-cancellable period followed by a rolling period

A lessee enters into a lease for retail space with a five year non-cancellable period. At the end of the non-cancellable period, based on the local common law in the applicable jurisdiction, the lease converts into a 'month to month' lease, whereas the lessee and the lessor may each terminate the lease with 1 months' notice with no contractual penalty owing. During this 'month to month' period, the lease payments are based on the last month's lease payment from the end of the non-cancellable period, indexed for inflation. The lessee has installed leasehold improvements with a useful life of 12 years that would have to be abandoned if it vacated the property. If the lessee were to vacate the space, the lessor would be able to lease the space to a new lessee with little to no cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes certain rights and obligations and local common law also provides the lessee with the right to continue occupying the space subsequent to the non-cancellable period. All of these rights should be considered in determining the lease term.

Step 2:

The non-cancellable period is five years, as neither the lessee nor the lessor may terminate the lease over this period of time.

Step 3:

The enforceable period of the lease is longer than five years. This is because the lessee has the right to continue occupying the space subsequent to the non-cancellable period based on common law in the applicable jurisdiction. The enforceable period is 12 years, because the leasehold improvements that the lessee would have to abandon if it vacated the property create a more than insignificant penalty (FRS 102 20.39) on the part of the lessee.

Step 4:

Considering all relevant facts and circumstances, the lessee determines the lease term to be 11 years. This consists of the non-cancellable period of five years, plus six of the seven years that extend beyond the point in time in which both the lessee and the lessor have a mutual termination option. This is because after six years, the leasehold improvements have a remaining useful life of only one year, therefore, the lessee

determines that at that point in time, the economic value of the leasehold improvements would be such that they would no longer be reasonably certain to continue utilising the leases space. The lessee would amortise the leasehold improvements over the 11 year lease term as they have to be abandoned if the property is vacated.

The assessment of lease term in the above example would change if the contract or laws in the local jurisdiction did not provide for renewal of the lease after the end of the non-cancellable period. If the non-cancellable period is five years with no extension option, the enforceable period and the lease term would be five years. Despite the fact that the lessee has installed leasehold improvements with a useful life significantly longer than the lease term, the lessee has no enforceable rights to remain in the retail space beyond the non-cancellable period. The lessee would amortise the leasehold improvements over the five-year lease term as they have to be abandoned if the property is vacated.



Example 4.5-2 – Determination of lease term – termination option only to the lessor

A lessee enters into a lease for retail space where the lessee is unable to cancel the contract until the end of four years. The lessor is able to terminate the lease any time after three years with no contractual penalties owing to the lessee. At the end of four years, if not terminated earlier by the lessor, the lessee must return the retail space to the lessor. The lessee has installed leasehold improvements with a useful life of four years that would have to be abandoned if it vacated the property. The retail space is also a 'flagship' location for the lessee, in a city where obtaining a similar property would be costly and difficult. If the lessor were to terminate the lease, the lessor would be able to lease the space to a new lessee with little to no cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes the rights and obligations applicable to determining the lease term.

Step 2:

The non-cancellable period is four years. Despite the fact that the lessor can terminate the lease at any time after year three, FRS 102 20.38(c) states that the non-cancellable period of a lease includes the period covered by a lessor-only termination option. This lessor-only termination option is effectively disregarded for purposes of determining the lease term.

Step 3:

The enforceable period is four years because a mutual termination option does not exist until the end of year four, and the non-cancellable period is four years; the enforceable period cannot be less than the non-cancellable period. At the end of year four, the rights and obligations arising under the contract end.

Step 4:

The lease term is four years as the non-cancellable period and the enforceable period are both four years. Despite the fact that the lessor can remove the lessee at any time after three years, this does not affect the determination of the lease term. From the perspective of the lessee, the lessor has the ability to enforce the contract for four years, without the cooperation or consent of the lessee.



Example 4.5-3 - Determination of lease term: Rights and obligations arising from customary business practices

A lessee uses an office building that is owned by its parent company. The subsidiary and the parent have no documented lease agreement in writing, however, a monthly amount is paid by the subsidiary to the parent for use of the office space. The subsidiary has used the office for a number of years and has an established head office at that location. If the lessee were to vacate the space, the parent would be able to lease the space to a new lessee with little to no additional cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

While no written lease contract exists, the definition of a contract is 'an agreement between two or more parties that creates enforceable rights and obligations'. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

It is therefore possible that customary business practices in this situation give rise to relevant enforceable rights and obligations depending on this assessment.

Step 2:

The non-cancellable period is zero years, as both parties may terminate the agreement at any point in time.

Step 3:

An entity considers all relevant facts and circumstances, including the cost of relocating its head office, the availability of similar office space, etc. and determines the lessee would suffer a more than insignificant penalty if it were to terminate the lease before the end of year 10. The lessor would not suffer an insignificant penalty at any time, however, the enforceable period extends until both the lessee and lessor would suffer no more than an insignificant penalty.

Step 4:

An entity applies judgment and considers all relevant facts and circumstances and concludes that the lease term is eight years. In doing so, an entity considers the factors noted in FRS 102 20.41 and 20.42. The lease term is less than the enforceable period in this case because the lessee assessing whether they are reasonably certain to continue exercising the tacit renewal options is a different threshold compared to the assessment of 'penalties' which is required in assessing the enforceable period.



Example 4.5-4 – Determination of lease term: More than an insignificant penalty to the lessor

Lessee operates a mine site in a remote area, which is costly to access and supply. Lessee enters into a lease contract with a lessor to rent extraction equipment with a useful life of five years. The lease has a one-year non-cancellable period. Based on the provisions of the lease contract, after one year, the contract renews monthly unless either party cancels it. The contract has no contractual penalties for cancellation. The lessee has alternative equipment it could lease from other suppliers who have equipment available near the mining site, therefore, shipping costs would be minimal. If the lessor were to terminate the lease, it would be responsible for the shipping and handling costs to bring the equipment back to the lessor's warehouse. These costs would be significant.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes the rights and obligations applicable to determining the lease term.

Step 2:

The non-cancellable period is one year, as neither the lessee nor the lessor may terminate the lease over this period of time.

Step 3:

The enforceable period is five years because it is not until this point in time that the lessee and the lessor both would suffer no more than an insignificant penalty by terminating the lease. At the end of year one, the lessee may cancel the lease and it would not suffer a significant penalty because it could obtain the equipment from another vendor with little cost incurred. The lessor would continue to suffer an economic penalty throughout the useful life of the equipment as lessor cancelling the lease would result in the lessor being required to pay significant shipping and handling costs to move the equipment back to its warehouse.

Step 4:

The non-cancellable period (minimum) is one year and the enforceable period (maximum) is five years, therefore, the lease term is between one and five years. FRS 102 20.40 states that 'an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease...', meaning an entity determining the lease term in this situation, whether it be the lessee or the lessor, must assess the lessee's likelihood of exercising its termination options, which exist continuously between the end of year one and year five. Applying judgment and considering all relevant facts and circumstances, the lease term is assessed as three years. This is based on the criteria noted in FRS 102 20.41 and 20.42, which provides guidance on assessing lessee-only options in a lease contract. Entities would consider, for example, the extent to which the existing equipment is integrated into the lessee's operations and the cost of lease payments compared to current market rates for similar equipment.



4.6 Revisions to the Lease Term

A lessee is required periodically to reassess whether it is reasonably certain to exercise extension and termination options and to revise the lease term if there is a change. The lease term may also change due to modifications to the lease contract.

Reassessment of reasonable certainty of exercising or not exercising an option

The requirement to reassess the reasonable certainty of exercising an extension option or not exercising a termination option apply to a lessee and not to a lessor.

Changes in the lease term may occur due to a change in an entity's intentions, the entity's business practice, and other circumstances unforeseen since it was first estimated.

A lessee is required to reassess the likelihood of it exercising or failing to exercise options upon the occurrence of either a significant event or a significant change in circumstances that:

- a. is within the control of the lessee; and
- b. affects whether the lessee is reasonably certain to exercise an option not previously included in the determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

On its own, a favourable or unfavourable change in market rental rates therefore does not trigger a reassessment as changes in market rental rates are not 'within the control of the lessee'.

Significant events or changes in circumstances requiring a reassessment of the lease term include:

- ▶ Significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- ▶ A significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- ▶ The inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- ▶ A business decision of the lessee that is directly relevant to exercising, or not exercising, an option (for example, to dispose of a business unit within which the right-of-use asset is employed).



Example 4.6-1 – Reassessment of lease term: Event not within the control of the lessee

Entity A obtains a retail space on lease from Entity B. The non-cancellable period of the lease is five years and the lease provides an option to Entity A to extend the lease for a further period of five years.

The retail space is in a central location with high visibility. At the commencement of the lease, Entity A determines that it is reasonably certain to exercise the extension option. Accordingly, Entity A determines the lease term to be 10 years.

Scenario A:

Three years after the lease commencement, Entity A's competitor opens a large retail outlet near Entity A's premises. However, it is not expected to significantly affect Entity A's business plans as Entity A has undertaken mitigating actions including further diversification.

Assessment

It should be noted that a change in circumstances is not in and of itself a triggering event for lease term reassessment. Entities may need to reassess the reasonable certainty of exercising renewal or termination options as a result of their actions undertaken in response to the change in circumstances.

In this case, the change in circumstance i.e. opening of the competitor's outlet, is not within Entity A's control. Entity A does not expect a change in its business plans as a result of the change in circumstances and has not taken any action in response to the change. Therefore, Entity A does not reassess the lease term at the end of three years.

Scenario B:

Three years after the lease commencement, Entity A's competitor opens a large retail outlet near Entity A's premises, which adversely affects consumer traffic to Entity A and revenue generation. As a result, Entity A's management has decided to relocate the store to another part of town and this is demonstrable in its business plans.

Assessment

In this case also, the change in circumstance i.e. opening of the competitor's outlet, is not within Entity A's control. However, Entity A has taken action in response to the change i.e. it has decided to relocate the store to another part of town. This action by Entity A would trigger a reassessment of the renewal option and the lease term.



Example 4.6-2 – Reassessment of lease term: Event within the control of the lessee

Entity A obtains an office building on lease from Entity B for a period of 10 years with a non-cancellable period of five years. After five years, Entity A has an option to terminate the lease with a three-month notice. At the commencement of the lease, Entity A is reasonably certain not to exercise the option to terminate the lease and accordingly determines the lease term to be 10 years.

At the end of three years, Entity A divests a major business division, which results in a substantial reduction in its staff. Entity A needs a smaller office space than the current office building after the divestiture.

Assessment

Divestiture of the business division is a significant event that is within the control of Entity A and affects whether Entity A is reasonably certain not to exercise the termination option. Therefore, Entity A reassesses the lease term at the end of year three. It concludes that it is reasonably certain to exercise the termination option at the end of five years and the lease term is reassessed to be five years. The lease liability and the right-of-use asset are accordingly remeasured.

The requirement to reassess the reasonable certainty of options being exercised upon the occurrence of a significant event or change in circumstances are not applicable to the lessor. Therefore, Entity B does not reassess the lease term at the end of three years. Entity B revises the lease term if there is a change in the non-cancellable period of the lease.

Therefore, assuming that Entity B had determined the lease term to be 10 years at commencement, it will revise the lease term to five years when Entity A gives notice to Entity B of exercising the termination option.

Reassessment of lease term due to change in the non-cancellable period

The requirement to reassess the lease term due to a change in the non-cancellable period applies to both the lessee and the lessor.

If there is a change in the non-cancellable period of the lease, the entity is required to revise the lease term. Following are examples where the non-cancellable period of the lease will change:

- ▶ The lessee exercises an option not previously included in the entity's determination of the lease term;
- ▶ The lessee does not exercise an option previously included in the entity's determination of the lease term;
- ▶ An event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term;
- ▶ An event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

It should be noted that the lessee is required to reassess the likelihood of whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

The lessor is not required to reassess the reasonable certainty of the lessee exercising an extension option or not exercising a termination option. The lessor reassesses the lease term when the lessee actually exercises an option not previously included in the determination of the lease term or does not exercise an option previously included in the determination of the lease term.

Revisions to original estimates of the lease term resulting from reassessments as to the likelihood of exercising options result in remeasurement of the carrying value of leased assets and liabilities. This is discussed in sections 5.6 and 5.7 below.

Remeasurements due to Modifications to the Lease Contract

The lease term may be changed if the lessee and lessor agree to modify the lease contract (as distinct from re-estimating the lease term due to revising judgments about whether options will be exercised). Contract modifications, which also result in remeasurement of the lease assets and liabilities, are discussed in Chapter 5.7 below.

5. Lessee accounting - recognition and measurement

At the commencement date of a lease, i.e. the date on which the lessor makes an underlying asset available for use by a lessee, the lease liability and right-of-use asset comprise the items noted below. It should be emphasised that a lease is recognised as at the commencement date. A lease is not recognised until this point in time, therefore, a lessee entering into a lease agreement with a lessor does not trigger the recognition of assets and liabilities until the commencement date of the underlying lease contract.

BDO comment - Commencement date and interaction with lease payments

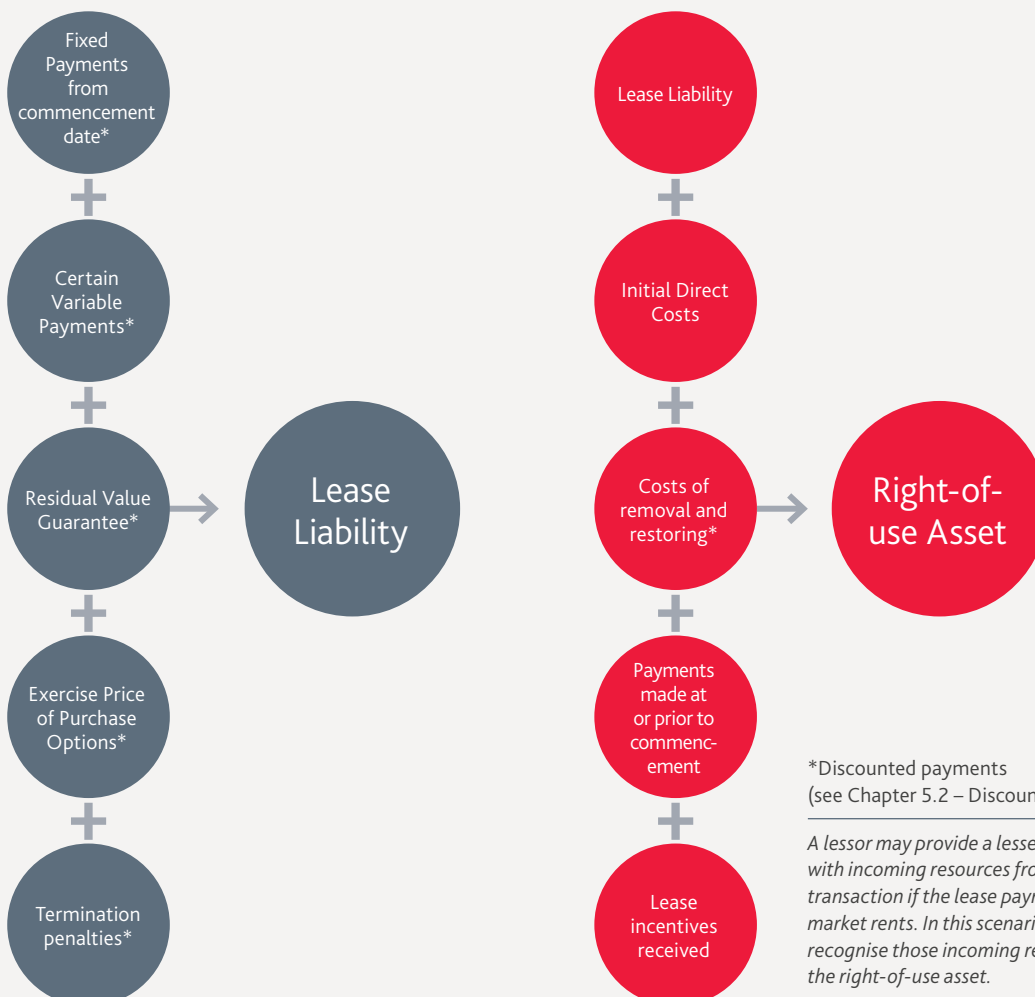
The commencement date of a lease is the date on which the lessor makes an underlying asset available for use by a lessee and the commencement date is when the lessee recognises a lease liability and the associated ROU asset (FRS 102 20.45).

The commencement date may be the same date as when lease payments become due, or it may be before or after.

If the commencement date is before the date when lease payments become due, the lease liability and ROU asset are still recognised. This may happen if for example, a lessor makes a retail space available to the lessee for 2 months for the lessee to 'fit out' and renovate the space. When the space is made available to the lessee, the lease will have commenced regardless of the fact that lease payments may not be due, therefore, the lessee must recognise the lease liability and ROU asset at the commencement date. The lessee will also begin recognising finance expense on the lease liability and the depreciation of the ROU asset.

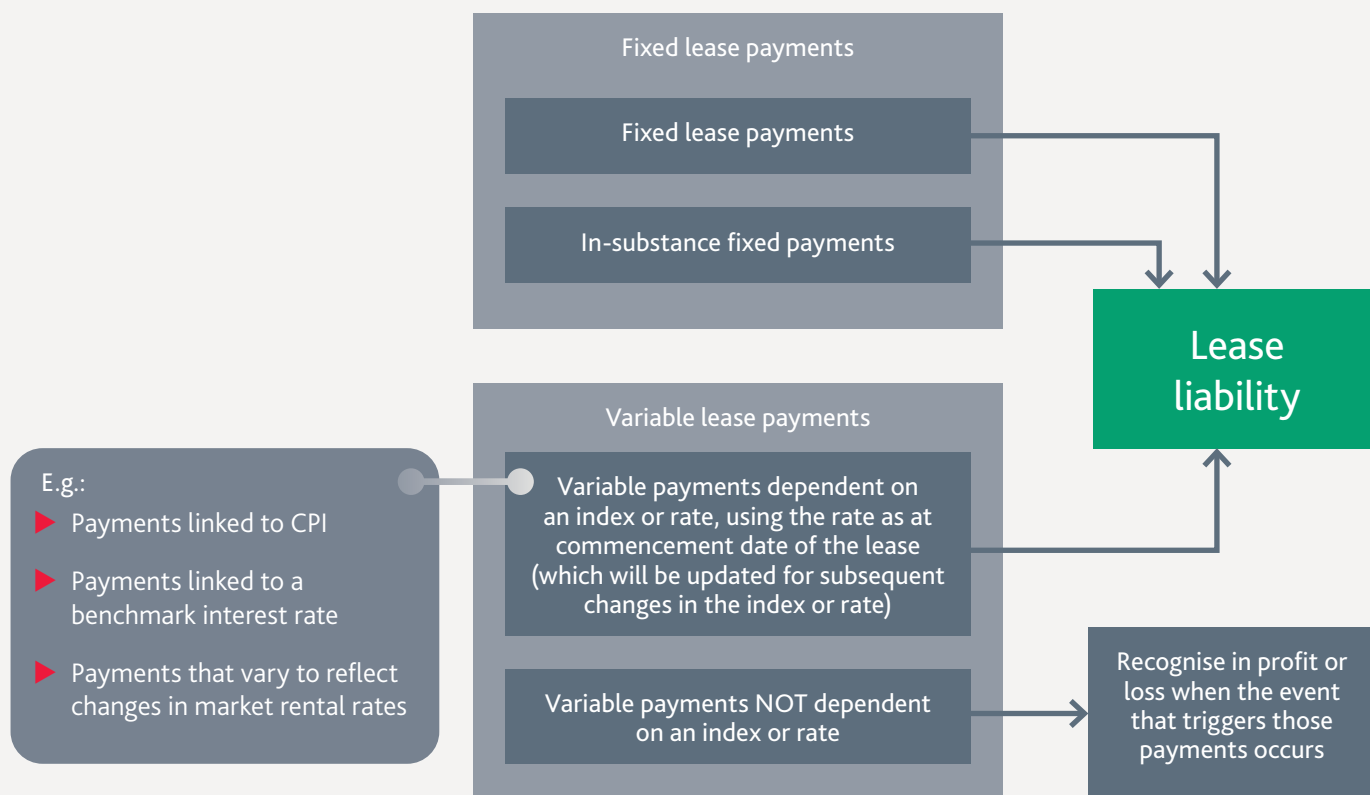
If the commencement date is after the date when lease payments become due (e.g. an upfront deposit), the lessee would recognise any lease payments made as an asset, being payments made prior to the commencement date. This asset will form part of the ROU asset once the commencement date occurs (FRS 102 20.47(b)).

The initial recognition of a lease is summarised as follows:



5.1 Lease Liability – Initial Recognition

The initial measurement of the lease liability is made up of several components, as illustrated in the flowchart below:



All components of the liability (fixed lease payments, in-substance fixed payments and variable payments dependent on an index or rate) are summed and discounted at an appropriate rate (see Chapter 5.2).

The following components are included in lease liability to the extent that they arise over the lease term (as defined in Chapter 4):

Fixed Payments

These include the set payments outlined in the lease contract. Some payments may be structured in a way such that they appear to have variability, but based on their nature or circumstance are unavoidable and therefore are 'in-substance fixed lease payments'. In-substance fixed lease payments may take several forms:

- ▶ Payments based on a presumed underlying assumption (e.g. that a leased asset will have to operate during the period), or payments that must be made only if an event occurs that has no genuine possibility of not occurring.
- ▶ Payments structured as containing genuine variable components, where the variable component will be resolved during the term of the lease (e.g. payments that become fixed once the lessee's base level of use of the asset has been established in the first year). Such payments become in-substance fixed payments when the variability is resolved.
- ▶ There is more than a single set of potential payments a lessee may have to make, but only one option is realistic.
- ▶ There is more than a single set of potential payments, but at least one must be made. In this case, the minimum (on a discounted basis) payments are the fixed lease payments.

Example 5.1-1 – In-Substance Fixed Payments

Below are several examples of scenarios in which it is considered whether variable payments are in-substance fixed payments.

Scenario #1 – Low minimum payments

Lessee enters into a 15-year lease of retail space in a shopping centre. The minimum rent is £100 per annum, unless sales exceed £1,000 per annum. If sales revenue exceeds £1,000 per annum, the lease payments are £50,000. The lessee has historically generated sales revenue at its retail locations of between £150,000 and £250,000 per annum. The store must operate within certain specified regular operating hours.

Analysis – the lease contract technically specifies variable payments in that rental payments can be either £100 or £50,000. However, it is not realistically possible that the lessee will have less than £1,000 in sales per annum given its history with past retail locations. In this case, there is no true variability in the lease payments as only one outcome is realistically probable to occur. The lessee would include the lease payments of £50,000 per annum in its initial measurement of the lease contract.

Scenario #2 – Payments entirely based around sales

Lessee enters into a 15-year lease of retail space in a shopping centre. There are no fixed lease payments. Lease payments are 5% of annual sales. The lessee demonstrated to the lessor in negotiating the contract that it generates at least £125,000 per annum at each location, and on average, £150,000.

Analysis – Although there is a high degree of certainty that the lessee will incur a lease expense of at least £6,250 (£125,000 * 5%) per annum, variable lease payments that are linked to the future performance or use of an underlying asset are excluded from the definition of lease payments. Consequently, no liability is recognised for those variable lease payments.

Scenario #3 – Consumables contract attached to a lease

Lessor leases medical equipment to hospitals and sells consumables used in the operation of the equipment. Lessor grants the lessee (a hospital) the right to use the equipment at no cost for a period of 10 years. However, in return, the customer agrees to the following:

- ▶ The lessee is not obligated to a minimum purchase of consumables, but lessor must be the exclusive supplier of consumables if the lessee chooses to purchase them.
- ▶ The price per consumable ordered is £10.
- ▶ Based on past experience, the lessee estimates consumption of 25,000 consumables per annum. At a minimum, the lessee believes 5,000 will be used.

Analysis – the contract does not contain a minimum order for consumables that the lessee must place. Consequently, as with scenario #2, because the variable payments are linked to the future use of the medical equipment (payments for the equipment are included in the price of the consumables), they are excluded from the definition of lease payments and no lease liability is recognised. Even if there is a high probability that a particular number of consumables will be ordered due to operational needs, this does not affect the conclusion. However, if the contract contained a minimum order quantity, this would give rise to the need to record a lease liability.

Variable Payments

Variable lease payments can take multiple forms. They may be indexed to a rate such as inflation, specified indices or the consumer price index, take the form of a market rent review or be linked to the performance of the asset itself (e.g. a percentage of sales for a retail store in a shopping centre).

The treatment of variable lease payments is summarised as:

Variable payments that depend on an index or a rate

- ▶ Include in the initial measurement of the lease using the index or rate as at the commencement date.
- ▶ Remeasure lease in the period the rate or index changes (see section 5.6).

Other variable payments

- ▶ Do not include in the initial measurement of the lease.
- ▶ Recognise in profit or loss (or in the carrying value of another asset as required by another Standard) when the event or condition that triggers the payments occur.

For variable payments that depend on an index or rate, FRS 102 20:51(b) provides (emphasis added):

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- (a)
- (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 FRS 102 20.53 and 20.54)
- (c) ...
- (d) ...
- (e) ...

It should be noted that, for the purpose of initial measurement of lease liability, lessees are not required or permitted to estimate future changes in the index or rate on which the variable payments depend.

Example 5.1-2 – Variable Lease Payments indexed to an interest rate

Lessee enters into a lease contract for a lease term of five years with annual lease payments of £100,000 per annum. These payments are indexed to a published benchmark interest rate in the jurisdiction in which the lessee operates, such that the lease payments for each year will be based on the interest rate as at the end of the previous calendar year (i.e. the interest rate as at 31 December 20x0 will determine the lease payments 20x1). As at the commencement of the lease, the applicable interest rate was 5%.

If the published benchmark interest rate remained at 5% over the five-year lease term, the cash flows would be as follows:

Year	Cash flows (rounded)
1	100,000
2	105,000 (100,000 * 1.05)
3	110,250 (105,000 * 1.05)
4	115,762 (110,250 * 1.05)
5	121,551 (115,763 * 1.05)
Total	552,563

Assessment

The lease agreement provides for escalation in lease payments based on the index rate and not movement in the index rate. As required by FRS 102 20.51(b), variable lease payments that depend on an index or rate will be initially measured using the index or rate at the commencement date.

In this example, the published benchmark index rate at commencement date is 5%. Even if there is no change in the benchmark interest rate during the entire period of the lease term and it remains at 5%, as per the terms of the agreement, the lease payments will increase at a rate of 5%. Therefore, for initial measurement of lease liability, the lessee needs to consider lease payments escalating at 5%, which is the interest rate at the commencement date. The lessee is not required or permitted to forecast future interest rates for initial measurement of lease liability.

Example 5.1-3 – Variable Lease Payments indexed to movement in interest rate

Lessee enters into a lease contract for a lease term of five years with annual lease payments of £100,000 per annum. These payments are indexed to movement in published benchmark interest rate in the jurisdiction in which the lessee operates, such that the lease payments for each year will be based on the proportionate increase or decrease in interest rate as at the beginning of the current calendar year compared to the previous calendar year. For example, if the interest rate as at 1 January 20X1 is 6% and at 1 January 20X0 is 5%, and if the lease payment for the calendar year 20X0 is £100,000; the lease payment for 20X1 will be $£100,000 * 6\%/5\% = £120,000$.

As at the commencement of the lease, the applicable interest rate was 5%.

Assessment

In this case, variable lease payments depend on movement in published benchmark interest rate. If the published benchmark interest rate remained constant at 5% throughout the lease term, there will not be any change in the lease payments and the payments will remain at £100,000.

Therefore, for initial measurement of lease liability, the lessee considers lease payments at £100,000 for five years. The lessee is not permitted to estimate what it expects lease payments to be over the lease term.

Example 5.1-4 – Variable Lease Payments indexed to Consumer Price Index

Year One – Beginning of Lease

Lessee enters into a 10-year lease of property with annual lease payments of £50,000 payable at the beginning of each year. The contract specifies that lease payments will increase every two years in line with the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125.

The lessee has determined the appropriate rate to discount lease payments is 5% (see Chapter 5.2 for a discussion on how to determine the appropriate discount rate.)

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of £50,000, discounted at the interest rate of 5 per cent per annum, which is £355,391.

Assessment

Lessee initially recognises assets and liabilities in relation to the lease as follows.

DR Right-of-use asset	405,391	
CR Lease liability		355,391
CR Cash		50,000 (lease payment for the first year)

In measuring the lease liability, Lessee does not make any estimate of how future changes in CPI will impact future lease payments. Rather it assumes the initial lease payment will remain constant during the lease term.

Example 5.1-5 – Interaction Between Index-Linked Lease Payments and Rent Escalation Clauses

Entity K enters into a five-year lease with a base rental cost of £200 per annum payable in advance. The rent will escalate at a fixed rate for the first three years as follows:

Year 1	200
Year 2	202
Year 3	204

This escalation is meant to approximate increases in CPI; however, the increases are fixed and are not variable lease payments dependent on an index or rate.

For years four and five, the payments will be determined based on the CPI for the immediately preceding year (i.e. year four's lease payment will be based on the year three payment adjusted for the increase/decrease in CPI during year three, as determined on the first day of year four).

There are no floors or ceilings in the contract, therefore, the payments in years four and five may go up or down relative to year three depending on the movement in the CPI for year three.

The issue is which amounts for years four and five should be included in the measurement of the lease liability as at the commencement date.

Assessment

The lease payments in years one to three are fixed, and are therefore included in the measurement of the lease liability.

The lease payments in years four and five are 'variable lease payments that depend on an index or rate' (FRS 102 20.51(b)), and are therefore included in the measurement of the lease liability, but they are initially measured using the index or rate as at the commencement date.

One approach is that, applying FRS 102 20.51(b) literally, the lessee is required to base the years four and five payments on the index or rate as at the commencement date, which is a lease payment of £200. However, in our view this is not appropriate.

FRS 102 20.68(b) provides guidance on how the measurement of a lease contract functions when the change is due to a change in index or rate. It states that 'a lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.'

The fixed escalation clause and the escalation due to changes in CPI are 'linked' in that the payment in year four will be based on how movements in CPI affect the fixed payment in year three, which is 204.

When FRS 102 20.51(b) states that variable lease payments that depend on an index or rate are initially measured using the index or rate as at the commencement date, we believe that it should be read to mean that the fixed payments that exist as at the commencement date are used, not necessarily the payment in the first period of a lease contract. Therefore, since year three's lease payment is fixed as at the commencement date, and it will be the base for remeasurement in year four once the movement in CPI for year three is known, then year three's fixed payment should be used to initially measure the lease contract for years four to five.

Consequently, the following payment profile is required to be used in measuring the lease liability as at the commencement date.

Year 1	200
Year 2	202
Year 3	204
Year 4	204
Year 5	204

Example 5.1-6 – Measurement of Lease Liability for 'Interest-Only' Leases

Lessee enters into a seven-year lease where the notional capital of the underlying lease asset is £10,000. Annual payments are based on EURIBOR multiplied by the notional capital amount (e.g. EURIBOR * £10,000), payable annually in arrears, and the notional amount is due at the end of the lease term. EURIBOR as at the commencement date of the lease is 3%. The issue is whether any amount other than the £10,000 due at the end of the lease should be included in measurement of the lease.

Assessment

FRS 102 20.51(b) requires the lease liability to include 'variable lease payments that depend on an index or rate, initially measured using the index or rate as at the commencement date'. The only unknown element in the formula to determine the lease payments from years one to six is the EURIBOR rate, however, FRS 102 20.51(b) requires the lessee to use the rate as at the commencement date for initial measurement. Therefore, the lessee would include a payment of £300 (3% of £10,000) for years one to six and a payment of £10,300 for year seven, discounted using an appropriate rate. The lessee would be required to remeasure the lease at each reporting date as EURIBOR changes (see Chapter 5.6).

Common Area Maintenance Costs and Variable Lease Payments

As discussed in Chapter 3, lease contracts for multi-unit real estate (e.g. office buildings, shopping centres) often include common area maintenance costs, under which lessees are charged for their proportionate share of common costs, which may include utilities, security, cleaning, etc. These common area maintenance costs may be in the form of a percentage of rent, a fixed fee per square foot occupied, or as estimated 'instalment' payments, which are compared to final, actual costs on a regular basis.

As discussed in Chapter 3, lessees may elect, as a practical expedient by class of underlying asset, to

include non-lease components in the measurement of lease liabilities. In making this accounting policy choice, lessees should consider whether non-lease component payments would fall within the scope of 'other variable payments' (see above) and therefore not be included in the measurement of lease liabilities. This is illustrated in example 5.1-7 below.

Example 5.1-7 – Common Area Maintenance Costs

Lessee has entered into two real estate leases for retail locations in two different shopping centres.

Location A has common area maintenance costs which are charged as a set percentage of rent, which is pre-determined over the term of the lease. There is no comparison of actual costs to fees collected from tenants; all payments are final.

Location B has common area maintenance costs charged based on an estimated amount per square foot occupied, which is then compared to actual costs incurred every 6 months, with either a credit being issued to the tenants or an additional payment being required by tenants, depending on whether fees collected were sufficient to cover costs.

Assessment

Location A's common area maintenance costs are fixed, as they are set based on a portion of the rental payment each period. If Lessee elects the practical expedient to include non-lease components in the measurement of lease liabilities, then these common area maintenance costs would be included in the measurement. If Lessee elects to not include the common area maintenance costs in the measurement of the lease liability, then Lessee would need to determine whether the split between rental cost and common area maintenance fees approximates their standalone values. If they do not, then Lessee would be required to reallocate the payments between the lease and non-lease components.

Location B's common area maintenance costs are variable in nature, as they have true variability based on the amount of the costs that occur for the shopping centre in total for the period, and that variability does not arise from an index, rate or market rent review. Regardless of whether Lessee elects to utilise the practical expedient to include non-lease components in the measurement of lease liabilities, these common area maintenance costs would not be included in the measurement of the lease contract as they are variable payments that do not depend on an index or rate. Instead, the maintenance costs would be expensed in the period to which they relate.

If Lessee elects to not separate non-lease components, then it must determine how it accounts for the 'instalment payments' of common area maintenance costs for Location B. As the payments are not linked to an index or rate, and they have no floor or minimum value, the entire payment is accounted for as a variable payment until the variability is resolved (i.e. when the lessor assesses the final costs for the relevant period). Payments of common area maintenance costs prior to this event are accounted for as prepayments by the Lessee.



Example 5.1-8 – Variable Lease Payments not included in the Initial Measurement of the Lease

Assume the same facts as Example 5.1-4 except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from the leased property.

Assessment

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 5.1-4. This is because the additional variable lease payments are linked to future sales rather than to a rate or index.

Consequently, those payments are not included in the initial measurement of the leased asset and liability, and so will be recognised in each period in addition to the depreciation and interest charges arising from the amounts recorded on balance sheet.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

DR Right-of-use asset	£405,391
CR Lease liability	£355,391
CR Cash	£50,000 (lease payment for the first year)

Residual Value Guarantees

Some leases require the lessee to guarantee the value of an asset when it is returned to the lessor. These create an incentive for the lessee to maintain the asset properly and provide regular maintenance and upkeep, and mean the lessor is not exposed to risks of obsolescence thereby giving it greater assurance over the return it will earn over the period of the lease. The excess of the guaranteed value over the expected fair value of the asset at the end of the lease would result in the lessee having to make an additional payment to the lessor. Any amounts that a lessee expects to pay under residual value guarantees are included in the initial measurement of the lease liability.



Example 5.1-9 – Residual value guarantee included in lease payments

A lessee enters into a lease of a car with a lessor for a period of five years. The lease agreement contains a residual value guarantee under which the lessee guarantees that the car will have a fair value of £10,000 at the end of the lease.

At the lease commencement date, the lessee estimates that the fair value of the car at the end of the lease will be £6,000.

Assessment

The amount of residual value guarantee exceeds the expected fair value of the asset at the end of the lease by £4,000, which the lessee will need to pay to the lessor at the end of the lease. The lessee includes £4,000 in the initial measurement of the lease liability.

If the lessee's estimate of the fair value changes subsequently, the lease liability will be required to be remeasured.

Purchase and Termination Options

Amounts that a lessee expects to pay to either purchase an underlying asset or to terminate a lease by exercising a termination option, and which have therefore been included in the determination of the lease term, are also included in the initial measurement of the lease liability.

BDO comment

Determining whether a lessee is reasonably certain to exercise a purchase option at the end of a lease term may have a significant effect on the initial measurement of the lease liability and right-of-use asset recognised in the financial statements.

The amount of judgement involved in this assessment is especially high for lease contracts with a significant lease term, as uncertainties and assumptions inherently increase when the period of time covered by forecasts increases. It may therefore be appropriate to disclose the judgements and estimates made in accordance with FRS 102 8.6-7 Notes to the financial statement.

Other Consideration

A lease may include amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease. Such amounts do not give rise to a separate component of the contract, but are considered to be part of the total consideration. This is common in leases of real estate, which require payments for items that do not transfer a separate service, such as property taxes and insurance. The treatment of these payments would differ from payments made for maintenance costs (such as common area maintenance costs in multi-unit property leases), which do transfer a service to the lessee and are in the scope of Section 23 Revenue from contracts with Customers. The lessee first needs to determine whether there are certain payments that relate specifically to a particular (lease or non-lease) component of the contract. This entails careful consideration and the exercising of judgment. Payments that cannot be directly attributed to the individual (lease or non-lease) components are then allocated on a relative stand-alone basis to the lease and non-lease components.

However, for additional costs that are considered to form part of the lease payments, it is also necessary to determine whether these constitute variable lease payments and, if so, whether they are based on an index or rate.

Example 5.1-10 – Non-refundable value-added taxes (VAT)

A lessee enters into a lease of a property for 10 years for annual lease payments of £3 million, payable quarterly in advance. In addition, the lessee will pay a 10% value-added tax (VAT) to the lessor, who must remit the tax to the applicable government. As the lessee operates in a specific industry, based on the applicable tax law, 50% of the VAT is non-recoverable.

Assessment

The payment of the VAT to the lessor could be viewed as not being a 'lease payment' as it is not a payment relating to the right to use an underlying asset; it is a charge levied by a government relating to goods and services with the lessor acting as collection agent for the government. Under this approach, the VAT can be viewed as a payment imposed by a government. The VAT would not be included in the measurement of the lease liability or right-of-use asset.

Another view might be that the VAT is an initial direct cost of the right of use asset. However, the obligation to pay the VAT would only arise at the related tax point (often the invoice date), meaning that only the first quarter's VAT would be capitalised.

5.2 Discount Rate on Initial Recognition

All the components of the lease liability as described in Chapter 5.1 are required to be discounted to reflect the present value of the payments. The discount rate to use is the rate implicit in the lease, unless this cannot readily be determined, in which case the lessee's incremental borrowing rate or obtainable borrowing rate is used instead.

Where a charity or other public benefit entity is unable to readily determine either the interest rate implicit in the lease, or the lessee's incremental or obtainable borrowing rate for a lease, the entity is required to use the rate of interest that it would otherwise obtain on deposits held with financial institutions. This might be the option most suitable for charities that never or seldom borrow.

The definition of the lessee's incremental borrowing rate states that the rate should represent what the lessee 'would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.'

The obtainable borrowing rate is the rate of interest that 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.

BDO comment

Use of rate implicit in the lease vs. incremental borrowing rate vs. obtainable borrowing rate

The rate implicit in the lease is the rate that would cause the present value of the lease payments and unguaranteed residual amount to equal the sum of the fair value of the underlying asset(s) and initial direct costs incurred. Using the implicit rate presents the true financing cost of leasing an asset as opposed to paying for it up-front or buying it outright without financing.

Allowing the incremental or obtainable borrowing rate to be used acknowledges that a lessee is often not able to determine the implicit rate. A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (i.e. a below market interest rate), but also charge above-market lease rentals to compensate for the low interest rate). Ultimately, to calculate the rate implicit in the lease requires not only information about the fair value of the leased asset at the start of the lease, but also its 'unguaranteed residual value' (the fair value at the end of the lease if the residual value is not being guaranteed). However, in many leases it will not be possible to make a reliable

estimate of this, particularly where the lease term is less than the leased asset's useful economic life.

Interest rate implicit in the lease for lease and non-lease components

If a lessee uses the interest rate implicit in the lease to measure leases (not the lessee's incremental or obtainable borrowing rate), the lessee must also consider lease and non-lease components. While Section 20 Leases contains a practical expedient that permits lessees to combine lease and non-lease components in the measurement of a lease contract (e.g. an automobile lease payment with built in maintenance services), in our view, lessees still must bifurcate these payments for purposes of determining the rate implicit in the lease.

In determining the interest rate implicit in the lease, lessees must still comply with the definition, which states that it is 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'. The term 'lease payments' is defined as 'payments made by a lessee to a lessor relating to the right to use an underlying asset...', meaning that the input into the determination of the rate implicit in the lease relates only to lease components, not non-lease components.

This creates additional complexity for entities using the rate implicit in the lease for the measurement of lease contracts.

Timing of the determination of the discount rate

The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease. This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental or obtainable borrowing rate or the rate implicit in the lease. For example, credit deterioration of the lessee would affect the incremental borrowing rate and significant geopolitical or technological events could affect the fair value of the underlying asset, which would in turn impact the rate implicit in the lease.

In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as FRS 102 20.46 requires a lessee to measure the right-of-use asset at the commencement date. The applicable discount rate is a component of the measurement of the lease, therefore, it is determined at the same time as other components of the measurement of the lease.

For lessors, the guidance differs, as FRS 102 20.91 states that lease classification between operating and finance type occurs at the inception date. The applicable discount rate is a component in determining how a lease is classified, as it affects the criteria used to analyse whether a lease is finance or operating. Consequently, the discount rate is determined at the inception of the lease contract for lessors.

Discount rate for leases acquired in a business combination

FRS 102 19.19A includes the following requirements for the measurement of leases acquired in a business combination when the acquiree is a lessee (emphasis added):

The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Section 20 Leases in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

- a. leases for which the lease term (as defined in Section 20 Leases) ends within 12 months of the acquisition date; or
- b. leases for which the underlying asset is of low value (as described in Section 20 Leases).

The acquirer shall measure the lease liability at the present value **of the remaining lease payments as if the acquired lease were a new lease at the acquisition date**. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

This raises the question of whether, in a transaction where a business combination is effected through the acquisition of a separate legal entity (e.g. a corporation), when applying FRS 102 19:19A, does the acquiring entity determine a discount rate from its own perspective (i.e. the acquirer) or from the perspective of the acquiree? Note that if a lease is acquired by the acquirer in a business combination through methods other than the acquisition of a separate entity (i.e. a trade and asset purchase, which requires the acquirer to amend the underlying lease contract to make the acquirer the new lessee), then the lease is a new contract at the acquisition date, and the applicable discount rate would be determined from the perspective of the acquirer.

This affects the measurement of the lease contract when the lessee's incremental rate of borrowing is used, as the effects of various economic factors (in particular credit risk) are included when the rate is determined.

In a business combination where the lease liability and right-of-use asset are measured at an amount equal to one another, this will not have a net impact on goodwill. However, when leases have 'off-market' terms, then this will impact the determination of goodwill in the business combination because the off market terms will be reflected in the measurement of the right-of-use asset.

FRS 102 19:19A requires the acquirer to apply Section 20 Leases in measuring the acquired lease as if it were a new lease as at the commencement date. In measuring a new lease, entities must consider all relevant information in determining inputs such as the lease term, lease payments, etc.

In determining the discount rate used to measure the lease liability, assuming that the interest rate implicit in the lease is not available and the lease is not restructured at the date of the business combination, then the lessee's incremental or obtainable rate of borrowing is determined from the perspective of the party to the contract (i.e. the lessee / acquiree in the business combination).

Regardless of the fact that the lease acquired is a new lease from the perspective of the acquirer, the initial recognition is still driven by the guidance in Section 20 Leases, therefore, the 'lessee' remains the acquiree in the business combination. This means that the subsidiary cannot default to the parent's incremental or obtainable borrowing rate.

However, the acquirer's incremental or obtainable rate of borrowing may be relevant if the leases acquired in the business combination are simultaneously restructured at the time of the business combination to include the addition by the new parent of credit enhancements to the lessee (e.g. a guarantee provided by the parent to the lessor). In such cases, the credit enhancement is considered in the determination of the incremental rate of borrowing, and hence in the initial measurement of the lease contracts in the acquirer's purchase price allocation.

Determining the incremental borrowing rate

Section 20 Leases does not contain significant guidance on how to determine the incremental borrowing rate beyond the definition provided (emphasis added):

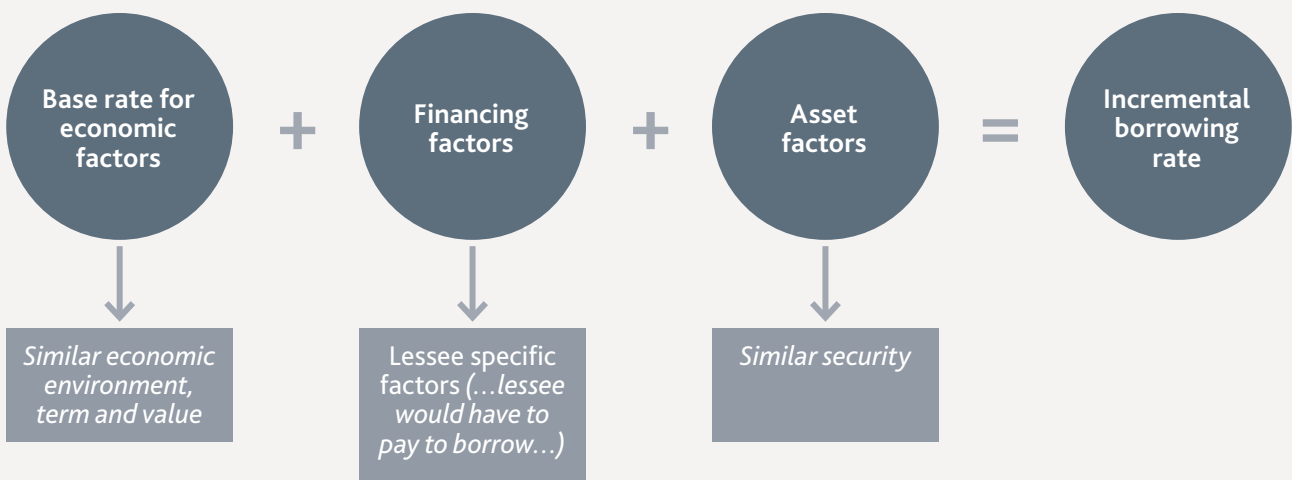
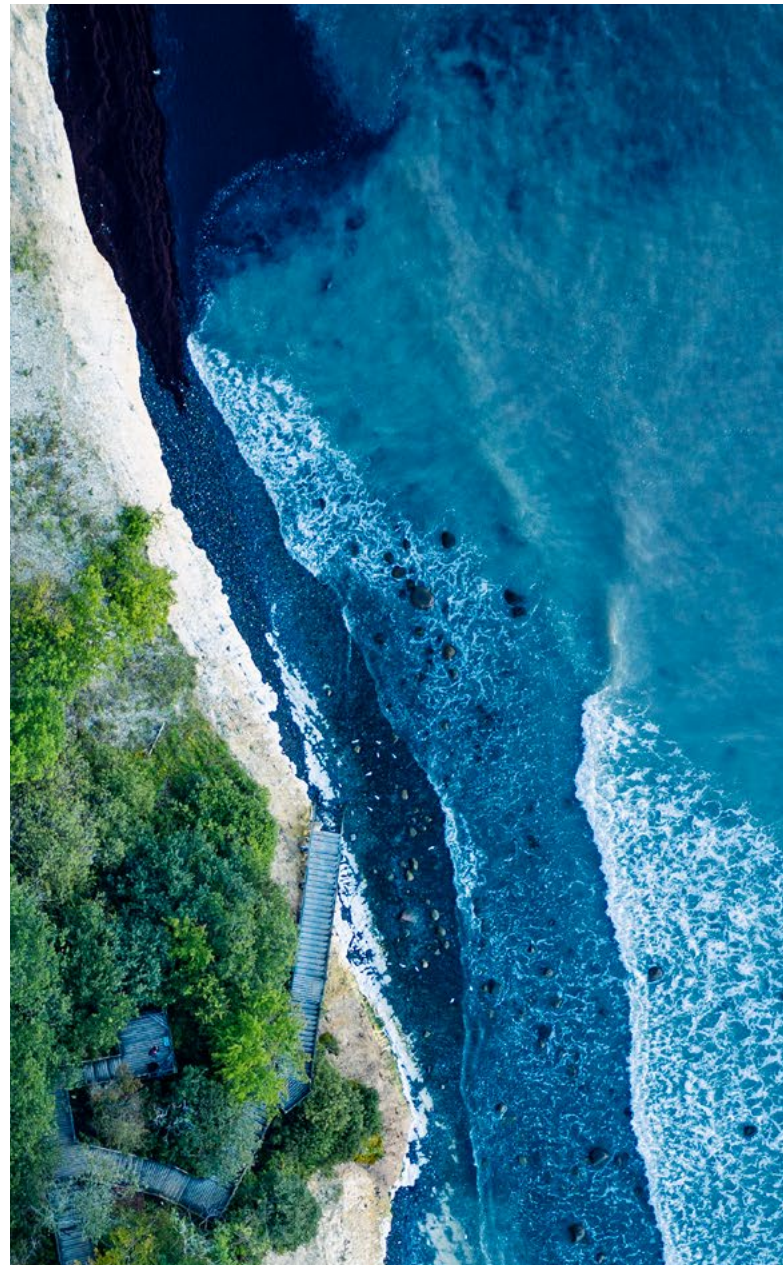


The rate of interest that a lessee would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.

In the absence of specific requirements in FRS 102, preparers will have to apply judgment in determining the incremental borrowing rate. For entities with relatively small lease portfolios that are not material in the context of the entity’s financial statements, then the work effort involved in determining the incremental borrowing rate for those leases may be lower. For entities with significant lease portfolios, the determination of the discount rate may have a very material impact on the statement of financial position as well as financial performance.

Determining the incremental borrowing rate is more complex than simply determining the weighted rate that an entity pays on its current borrowings. Such borrowings may have economic characteristic entirely dissimilar to the definition of the lessee’s incremental borrowing rate as noted above.

In our view, the following methodology may provide a reasonable base for determining the incremental borrowing rate for a lease, as it incorporates the key elements denoted above in italics.



Base rate for economic factors: similar economic environment, term and value



The starting point in estimating the incremental borrowing rate is a 'base rate', which may be a risk-free rate derived from government bonds or other types of low risk financing. To achieve a 'similar economic environment', this rate should consider the applicable geographic location where the lessee operates. For example, the risk-free rate in the United States of America and sub-Saharan Africa would be very different.

The base rate should also consider the term of the lease, as risk-free rates differ depending on the period of time of the lending arrangement. For example, the risk-free rate for a three-year lease of equipment would differ from the risk-free rate for a 20-year real estate lease, as the cost of borrowing tends to increase as the period of time increases.

An issue arises in developing this base rate, as there are often significant differences in the timing of cash flows between risk-free rates and leases. Low risk lending arrangements, such as government bonds, tend to have cash flows heavily weighted towards the end of the term (i.e. a 'bullet loan'). In some cases, all cash flows, including interest, may be deferred until this point in time. In contrast, most leases have period cash flows that occur over the lease term on a weekly, monthly, or annual basis. However, Section 20 Leases does not contain specific guidance for the determination of the incremental borrowing rate.

Many lease contracts are amortising in nature with regular payments, meaning that an appropriate approach would be to use readily observable rates for loans that would also be amortising in nature (e.g. an amortising government bond with similar payment profile to the underlying lease).

One approach could be to use the yield curve for government bonds (which have a bullet repayment on maturity), with an appropriate rate being used to discount each of the lease payments. This would result in the determination of a 'base rate' which reflected the capital repayment profile of the lease.

An alternative approach which may be acceptable to account for this difference in the timing of cash flows (depending on the contractual payment terms of the lease) would be for entities to select reference bonds with cash flows that approximate the weighted cash

flows for the underlying lease. For example, the rate attributable to a 10-year property lease with monthly cash flows may be satisfactorily represented by a five-year bond with a bullet capital repayment on maturity. The weighted cash flows of the bond would be approximately five-years. However, this may not always be an appropriate approach, for example where rates are low for the initial five year period but increase sharply for years five to ten.

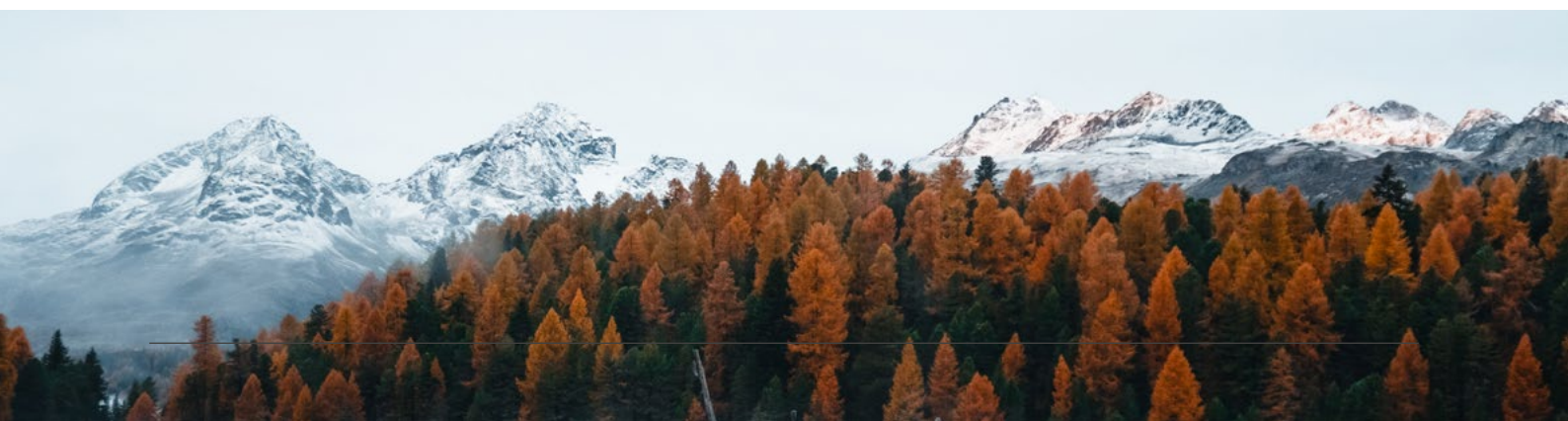
In applying the concept of 'similar security' for the purpose of determining the incremental borrowing rate, a lessee uses the right-of-use asset granted by the lease and not the fair value of the underlying asset. This is because the rate should represent the amount that would be charged to acquire an asset of similar value for a similar period. For example, in determining the incremental borrowing rate on a five year lease of a property, the security for the portion of the asset being leased (i.e. the five year portion of its useful life) would be likely to vary significantly from the outright ownership of the property, as outright ownership would confer rights over a period of time that would typically be significantly greater than the five-year right-of-use asset contained in the lease.

In practice, judgement may be needed to estimate an incremental borrowing rate in the context of a right-of-use asset, especially when the value of the underlying asset differs significantly from the value of the right-of-use asset.

An entity's weighted-average cost of capital ('WACC') is not appropriate to use as a proxy for the incremental borrowing rate because it is not representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings. The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated.

Financing factors

As the 'base rate' discussed above represents a risk-free rate of borrowing, it must be adjusted to consider the credit risk of the entity. Entities may consider using readily observable rates for loans with similar payment profiles as a starting point.



Once an appropriate base rate is determined, it must be adjusted for characteristics of the lease that are dissimilar from the reference rate. This may be accomplished by obtaining credit spread information for the entity itself from recent borrowings; however, obtaining this information specific to one particular entity may be difficult in practice. Entities may also consider utilising industry data and making adjustments for the entity's specific credit risks relative to industry composites.

It should be noted that in group structures where central treasury functions obtain financing for groups across multiple jurisdictions, special considerations may apply. It is common for conglomerates and large corporate entities to centralise their borrowing function in order to lower borrowing costs for the group as a whole through economies of scale. In determining an appropriate incremental borrowing rate, entities must consider that it would generally not be appropriate to use a 'consolidated' borrowing rate for the group as a whole. This is because a group borrowing rate generally considers the blended credit characteristics of all entities in the group, which will normally differ from the terms of a lease obtained in each individual subsidiary. For example, a group treasury rate for a revolving credit facility may consider guarantees and diversification adjustments, which lower the rate for the group as a whole and not for each separate subsidiary. Upon consolidation of many entities within a corporate group, the incremental borrowing rate may differ significantly across different entities that operate in different geographic regions and industries, even if the underlying leased asset is similar.

Special consideration: foreign currency leases

Entities may enter into lease agreements in currencies other than their functional currency. For example, an entity may have a functional currency of Euro, and enter into leases for aircraft, which are routinely denominated in US dollars worldwide. In our view, entities should determine their incremental borrowing rate based on the rate of interest they would have to pay in the same currency in which the lease payments are denominated.

In some situations, an entity may utilise foreign currency derivatives in order to achieve a similar economic outcome as borrowing in the foreign currency itself. Using the example noted above, the entity may acquire a loan in Euros and then acquire a cross-currency swap to economically modify the payments to be in US dollars. In a situation where an entity routinely enters into such arrangements, then depending on the precise facts and circumstances, it may be appropriate to use this 'swapped' borrowing rate in determining the incremental borrowing rate for a lease in the swapped currency. Factors to consider include the approach that an entity actually uses in practice for borrowing USD and which approach would give a lower cost of borrowing.

Special consideration: use of 'real' discount rates and interrelationship with inflation

In some jurisdictions, lease payments are adjusted on a regular basis to reflect the accumulated inflation of the past twelve months. This may be more common in jurisdictions with relatively high rates of inflation. This results in the lease having variable payments that are dependent on an index or rate. This raises the question of whether a nominal or a real rate should be used in determining the lessee's incremental rate of borrowing.

A nominal discount rate does not consider inflation, whereas a real discount rate does. A real discount rate aims to remove the effects of inflation to reflect the real cost of debt to the borrower and thus is lower than the nominal discount rate.

The lessee's incremental borrowing rate is defined as:



The rate of interest that a lessee would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.

The rate a lessee 'would have to pay to borrow' funds would be a nominal rate, not a real rate.

Therefore, in our view, a nominal rate should be used for discounting.

However, for leases that have inflationary increases (e.g. variable lease payments dependent on CPI or inflation), an alternative view may be acceptable. If the cash flows considered for measurement of lease liability reflect real cash flows, an entity may consider use of real discount rate.



Asset factors

In determining how the type of asset affects the incremental borrowing rate, entities should consider that a lease is in substance a 'secured loan', in that the lessor typically has recourse to repossess the underlying asset (which includes the lessee's right of use asset) if a lessee defaults.

Section 20 Leases intends the incremental borrowing rate to represent the rate that would be charged to purchase the right of use asset. However, there are conceptual differences in achieving this in practice. For example, a lessor is typically exposed to residual value risk in leasing to an entity, which it would be expected to incorporate into the rate implicit in the lease. In our view, it would not be appropriate for the lessee to incorporate an asset risk premium for residual value risk because this is not consistent with the definition of the incremental borrowing rate. While the incremental borrowing rate and the rate implicit in the lease share many characteristics, exposure to residual value risk via an asset risk premium is not the same as security risk that a lender bears through the term of a borrowing arrangement.

In our view, it would still be appropriate to adjust the rate by a value that considers a borrower's view as to the risk of the type of asset that is being leased (e.g. the risk related to repossessing right of use assets for laptop computers compared to commercial office space would differ substantially). Significantly different costs would exist for these two examples, and the ability of a lender to realise a residual amount from the underlying collateral would differ substantially.

Example 5.2-1 – Determination of Incremental Borrowing Rate for a Portfolio of Similar Leases

Note: this example illustrates the concepts discussed above in determining the discount rate for lease contracts where the lessee has a policy of using the incremental borrowing rate. Additionally, this example illustrates how a lessee may make materiality decisions concerning the discount rate in measuring lease contracts. Such decisions must be made by management with appropriate analysis to support the simplifications used. The decisions noted below may not be appropriate to every entity; careful analysis of the facts and circumstances in each case is required.

Entity L is a new freight and logistics firm that has entered into a large number of leases for railcars in order to transport its customers' goods. It has also

entered into a number of leases for smaller equipment such as automobiles and forklifts. The interest rate implicit in the leases is not readily determinable. Entity L has made an accounting policy choice to measure all lease liabilities using its incremental borrowing rate. In determining the discount rate to apply to the total portfolio of leases, Entity L elects to utilise the practical expedient to apply Section 20 Leases to a portfolio of leases with similar characteristics.

Entity L's major lease portfolio consists of two major types of railcars: heavy rail and light rail, therefore, Entity L will determine the discount rate for these portfolios of leases separately. These portfolios are hereafter referred to as the 'heavy portfolio' and 'light portfolio'. The smaller equipment lease portfolio (e.g. automobiles and forklifts) is referred to as the 'minor equipment portfolio'.

For all leases, Entity L will make quarterly payments in advance of equal amounts over the related lease term.

Entity L applies the methodology discussed in the previous section to determine the discount rate for these three portfolios.

Base rate for economic factors: similar economic environment, term and value

Heavy portfolio: Entity L analyses its portfolio of leases and notes that the lease terms vary between four and six years, with the leases being evenly dispersed over that period (in number and value). Consequently, Entity L concludes that the weighted average lease term is five years.

Entity L then reviews interest rates applicable to high quality bonds in its jurisdiction and notes that:

- ▶ The bonds pay interest quarterly and have 'bullet' capital repayments on maturity (in contrast to the lease liabilities which are amortising balances)
- ▶ Interest rates for bonds with maturities of between one and five years rise evenly over the four-year period

Consequently, Entity L concludes that a reasonable approximation of the 'base' rate will be obtained by referring to the interest rate for bonds with a 2.5 year duration. Utilising instruments with a duration equal to 50% of the weighted average lease term accounts for the fact that the referenced bonds are bullet loans with 'back loaded' cash flows compared to the cash flows of the lease, which are evenly dispersed. The base rate is determined to be 3.10%.

If the lease portfolio had been different, then additional analysis would have been required. For example, Entity L might have found that while the average lease term is five years, there are a significant number of leases in this portfolio with lease terms of 18 months – 2 years compared to another large number of leases with terms of seven-eight years. While the applicable reference bonds for these more granular segments carry different interest rates, Entity L would need to carry out a sensitivity analysis to determine whether the use of a single 2.5 year reference rate would potentially have a material impact in the measurement of the lease contracts.

In addition, if an approximation is used, it is necessary to revisit the approach as and when additional leases are added in future to determine whether the approximation remains acceptable.

Light portfolio: Entity L performs an analysis similar to above, noting that the average lease term in the light portfolio is three years. The applicable rate after referencing a series of high quality bonds in the applicable jurisdiction is 2.65%.

Minor equipment portfolio: The minor equipment portfolio is made of many different types of equipment with various lease terms ranging from one to four years, with lease terms and values evenly spread in this range. Entity L notes that the minor equipment portfolio is immaterial in comparison to its railcar portfolios and to the financial statements as a whole. Consequently, Entity L considers that it is acceptable to use a 3.00% discount rate for the minor equipment portfolio of lease contracts, rather than determining different rates for various sub-portfolios of different types of equipment with different lease terms. Entity L performs a sensitivity analysis and notes that a reasonably possible shift in the discount rate would not result in a material difference in the measurement of this portfolio. Although financing factors are also considered, an adjustment for asset factors is not considered necessary as its effect would be immaterial.

Financing factors

Heavy portfolio: to adjust the base rate for credit risk factors, Entity L refers to the spread between the credit rating of bonds in the reference portfolio compared to Entity L's own credit risk. The credit rating for the bonds in the reference portfolio were AAA, meaning they have a low risk of defaulting on the payments. Entity L consults with several banks in its jurisdiction and obtains a number of different interest rate 'spreads' between AAA borrowers and Entity L for loans of 2.5 years in duration. The average of these spreads is 1.75%.

Light portfolio: Entity L performs an analysis similar to above, however, for a reference portfolio with an average duration of 1.5 years (i.e. half of the light portfolio's weighted average lease term). The average of these spreads is 1.25%.

Minor equipment portfolio: Entity L considers the range of lease terms in this portfolio and the credit spreads for the heavy and light portfolios. It concludes that a reasonable approximation of the credit spread applicable to the minor equipment portfolio is 1.50%.

Asset factors

Heavy portfolio: the base rate and credit spread determined above relate to an unsecured borrowing position. Entity L notes that the security in its leases is the underlying right-of-use asset, therefore, an adjustment to the borrowing rate should take this into account. Entity L consults with several banks on the adjustment to the rate on a secured borrowing position. Entity L notes that in discussions with banks, they note that the underlying asset provides less relevant security than say, commercial real estate in a major city centre, since realising on the underlying security (rail cars) is more difficult and would include more significant costs. The adjustment for the asset factors is -0.45%.

Light portfolio: Entity L performs an analysis similar to above, however, the nature of the security (light rail cars) differs slightly. The banks that Entity L consults that light rail cars are used less frequently and have shorter useful lives, therefore, the nature of the security provides a lower adjustment than the heavy portfolio. The adjustment for the asset factors is -0.35%.

Minor equipment portfolio: Entity L performs an analysis similar to that of the heavy portfolio. As the minor equipment has a relatively short useful life, Entity L believes the adjustment for asset factors is minor. The adjustment for asset factors is -0.10%.

Conclusion

Combining the relevant factors together results in the following discount rates:

Heavy portfolio =	base rate + financing factors + asset factors
Heavy portfolio =	3.10% + 1.75% + (-0.45%)
Heavy portfolio =	4.40%
Light portfolio =	base rate + financing factors + asset factors
Light portfolio =	2.65% + 1.25% + (-0.35%)
Light portfolio =	3.55%
Minor equipment portfolio =	base rate + financial factors + asset factors
Minor equipment portfolio =	3.00% + 1.50% + (-0.10%)
Minor equipment portfolio =	4.40%

Determining the obtainable borrowing rate

Section 20 Leases does not contain significant guidance on how to determine the obtainable borrowing rate beyond the definition provided:

'The rate of interest that a lessee would have to pay to borrow over a similar term, an amount similar to the undiscounted value of lease payments to be included in the measurement of the lease liability.

In the absence of specific requirements in FRS 102, preparers will have to apply judgment in determining the obtainable borrowing rate.

The definition of the obtainable borrowing rate does not require the lessee to consider either the nature or quality of any collateral provided, nor the broader economic environment in which the transaction takes place. While this definition makes the obtainable borrowing rate simpler to determine than an incremental borrowing rate, it remains a rate that must reflect certain key terms and conditions of the lease — in particular, the lease term and the undiscounted amount of the lease payments.

Depending on the lease's specific terms, a lessee may be able to use an observable rate as an initial reference point when determining its obtainable borrowing rate. However, the lessee must then adjust that rate as necessary to ensure it meets the definition in Section 20 Leases.

In practice, adjustments to an existing borrowing rate may be required to reflect:

- ▶ the lease term;
- ▶ the value of the undiscounted lease payments; and
- ▶ changes in the cost of borrowing since the original borrowing was obtained, including movements in market rates and any changes in the lessee's credit risk.



Example 5.2-2 – Determination of Obtainable Borrowing Rate

Entity A enters a 5-year property lease commencing 1 January 20X1. Lease payments of £72,000 are required to be paid annually in advance. The total undiscounted payments to be made over the lease term are £360,000. Entity A concludes that it cannot readily determine the interest rate implicit in the lease. It chooses to determine its obtainable borrowing rate instead.

Determination of the obtainable borrowing rate by entity A

Entity A approaches its bank for a quote to borrow £360,000 over a 5-year term (matching the lease undiscounted amount and duration). The bank quotes an interest rate of 6% for such a loan.

Entity A therefore concludes that an appropriate obtainable borrowing rate for the lease would be 6.0%.



5.3 Right-of-Use Asset – Initial Recognition

The right-of-use asset's value is initially linked to the calculated value of the financial liability with several additional adjustments.

Initial Direct Costs

These are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. These might include costs such as finder's fees, commissions to agents for establishing the lease and legal fees.

BDO comment

Section 20 Leases emphasises that direct costs must be 'incremental' in the context of each individual lease (and not on the basis of a portfolio of leases). This precludes an entity from making an allocation of administrative costs relating to obtaining a lease, such as a portion of finance and management salaries. Such costs would not be incremental as they would be incurred regardless of whether an entity enters into a specific lease.

Shipping and installation expenses are common costs that lessees incur to be able to use underlying lease assets. For example, leased manufacturing equipment may require significant costs to install into a pre-existing assembly line.

The definition of 'initial direct costs' states that they are the cost of 'obtaining a lease'; it is unclear as to whether this means costs strictly related to executing the lease agreement (e.g. legal costs), or if this may include costs associated with the underlying asset itself.

In our view, it is preferable for a lessee to capitalise costs associated with the physical underlying asset (e.g. shipping and installation), as this produces consistency with the outcome if the lessee had purchased the asset outright. Despite this, since Section 20 Leases is unclear, we believe it is also acceptable for a lessee to expense initial direct costs that are associated with the underlying physical asset.

Removal and Restoration Costs

Some leases contain a requirement for lessees to return an asset in a specified condition, such that the lessee would be required to incur costs to restore it. Certain types of asset may also have significant transportation and removal costs to return them to the lessor as specified in the lease agreement.

These types of obligations may be incurred at the commencement date of a lease or as a consequence of using an underlying asset.



Example 5.3-1 – Initial Recognition of a Lease

Entity Z (the lessee) enters into a five-year lease of a floor of a building, with an option to extend the lease for a further five years. Lease payments are £50,000 per annum during the initial term and £55,000 per annum during the optional period, all payable at the beginning of each year. To obtain the lease, Entity Z incurs initial direct costs of £20,000 (£15,000 to the former tenant occupying the floor and £5,000 for real estate commissions). The lessor agrees to reimburse the lessee the real estate commission of £5,000.

At the commencement date, Entity Z concludes that it is reasonably certain to exercise the option to extend the lease. Therefore, the lease term is 10 years.

The rate implicit in the lease is not readily determinable. Entity Z's obtainable borrowing rate is 5% per annum and it is opting to use this rate rather than its incremental borrowing rate. This rate reflects the fixed rate at which it would have to pay to borrow over a similar term, an amount similar to the undiscounted value of lease payments.

Assessment

The entries required to record this transaction are as follows (see corresponding superscripts for notes reconciling each component of the entry):

To record the initial value of the lease asset and liability:

DR right-of-use asset	423,200 ¹
CR lease liability	373,200 ²
CR cash	50,000

1. £50,000 in advance plus PV of 4 payments at £50,000 and 5 payments at £55,000, discounted at 5%.

2. PV of 4 payments at £50,000 and 5 payments at £55,000, discounted at 5%.

To record the initial direct costs:

DR right-of-use asset	20,000
CR cash	20,000

To record lease incentive (the reimbursed real estate commission) relating to the lease:

DR cash	5,000
CR right-of-use asset	5,000

Lease Incentives

It is common in many leases for the lessee to receive a lease incentive at the commencement of a lease. These are commonly in the form of cash. Such incentives are deducted from the value of the right-of-use asset, as in the example above. However, an issue can arise where all lease payments are variable (meaning that it is possible that no lease liability will be recorded) and a lease incentive is received. This is illustrated in the following example.



Example 5.3-2 – Lease Incentives that Exceed Right-of-use Asset

Entity U enters into a 10-year lease contract for retail space where all of the lease payments are variable and do not depend on an index or rate (e.g. lease payments are based on a percentage of sales generated from using the retail space).

At the time of lease commencement, the lessee receives a £100,000 incentive from the lessor. There are no repayment conditions for the incentive.

Entity U measures the lease liability at zero as of the commencement of the lease, as the lease has no fixed payments, residual value guarantees, purchase options or in-substance fixed payments.

The lessee measures the right-of-use asset at an amount equal to the lease liability (i.e. zero), but must also apply FRS 102 20.47(b) and deduct the lease incentive from the carrying value of the right-of-use asset.

Assessment

Section 20 Leases does not contain specific guidance for circumstances in which a right-of-use asset might be recorded at a negative carrying amount. However, applying the requirements of FRS 102 20.47 results in a negative asset being recorded, which is subsequently accounted for applying the cost model (assuming the lessee is not using the revaluation model and the lease does not meet the definition of investment property).

Therefore, the lessee is required to record a 'negative right-of-use asset' and amortise the resulting credit to profit or loss over the shorter of the lease term and the useful life of the underlying asset (see Chapter 5.5 for discussion of the subsequent measurement of right-of-use assets).

Note that this example assumes the lease incentive is received in cash as at lease commencement. In our view, the conclusion would not change if the lease incentive were receivable as at commencement, assuming there are no conditions related to receipt of the lease incentive.

Costs of the lessee relating to the construction or design of the underlying asset

An entity may negotiate a lease before the underlying asset is available for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

If a lessee incurs costs relating to the construction or design of an underlying asset, the lessee is required to account for those costs applying other applicable Sections of FRS 102, such as Section 17 Property, Plant and Equipment or Section 18 Intangible Assets other than Goodwill and not Section 20 Leases as these are not payments made by the lessee for the right to use the underlying asset. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments.

Refundable security deposits

Lessees are often required to pay security deposits to the lessors, which are refundable at the end of the lease term. Generally, the deposits do not carry any interest and are repayable subject to the leased asset being maintained in the condition as required by the lease agreement.

The entire amount of the deposit is not a lease payment as it is refundable to the lessee at the end of the lease.

The deposit is a financial asset that will generally be within the scope of Section 11 Basic Financial Instruments. FRS 102 11.13 requires financial assets to be measured on initial recognition at their transaction price unless the arrangement constitutes a financing transaction (ie where payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate). If an arrangement constitutes a financing transaction, an entity is required to measure the financial asset at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

As refundable security deposits do not generally bear interest, the carrying value at initial recognition should be based on the present value of the future payments. This carrying value will be lower than the nominal amount of the receivable at the end of the lease term.

The difference between the nominal amount of the deposit and the carrying amount at the commencement of the lease is, in effect, an additional lease payment which is prepaid. As such, it should be added to the initial carrying value of the right-of-use asset. The right-of-use asset will then be depreciated over the lease term meaning the difference is released to profit or loss over the lease term as part of the depreciation expense.

Subsequent to initial recognition, a refundable deposit financial asset will generally be accounted for at amortised cost resulting in the recognition of interest income over the lease term.

Example 5.3-3 – Refundable interest-free security deposit

Entity A enters into a lease of office space with a lessor for a period of five years with annual lease payments of £2,000 paid in advance. The lease agreement requires Entity A to pay a security deposit of £1,000 on the commencement date of the lease. The deposit is refundable to the lessee without interest at the end of the lease term as long as the property is maintained in the condition as required by the lease agreement. If damage is done to the property by the lessee that is beyond normal 'wear and tear', the lessor has the right to use some or all of the deposit to repair the damage at the end of the lease term. The repayment of the deposit is not dependent on the change in value of the building itself.

The rate implicit in the lease is not readily determinable. Entity A's obtainable borrowing rate is 6% and Entity A has chosen to recognise the lease using this rate. The interest rate for a similar lending arrangement between Entity A and the lessor is 5%.

Assessment

Entity A is required to recognise a financial asset for the security deposit at fair value. The fair value of the security deposit would be £784, being the present value of £1,000 cash in-flow discounted for five years at a discount rate of 5%. Discounting is at the interest rate that reflects a lending arrangement between the lessee and the lessor, which is 5% in this case.

£216, which is the excess of the transaction price (£1,000) over the fair value (£784), forms part of the cost of the right-of-use asset.

Entity A will pass the following journal entry on the lease commencement date:

DR Right-of-use asset	216
DR Financial asset	784
CR Cash	1,000

The financial asset would be subsequently measured in accordance with Section 11 Basic Financial Instruments.

The adjustment to the right-of-use asset would be amortised as required by the subsequent measurement guidance in Section 20 Leases.

Public Benefit entities only - Value of social donation

Social donation lease arrangements exist where the lease payments are below market rent 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. A charity may enter into a social donation lease either as a lessee or lessor.

A charity lessee must use the information readily available to it to determine whether it is party to a social donation lease. This could include:

- ▶ information provided by the lessor about the discount or reduction in lease payments being given to the charity
- ▶ information about the lease payments for very similar assets made by lessees who are not charities

Social donation leases, by definition, contain a non-exchange component. The value of the incoming resources from the non-exchange component is recognised as part of the cost of the right-of-use asset.

Example 5.3-4 Value of a social donation (Public Benefit Entities only)

A charity enters into an agreement to use one floor of a five-storey office building for 5 years. The other four floors are occupied by the lessor who is a commercial business. The market rent for this floor is £120,000.

The lessor states that as part of its corporate social responsibility activities, it will give the charity a 60% discount on the office space so the charity will pay £48,000 per year instead. If the arrangement had not been available the charity expected to pay £85,000 for an office space elsewhere.

Assessment

Information available to the charity indicates there is a non-exchange component in the lease. Where the charity determines that it has received a donated facility under this arrangement it is the value to the charity of the office space that is important. The non-exchange component is £37,000 per year or £185,000 over the lease term – the difference between the value to the charity and the payments 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. FRS 102 SORP 2026 includes a model on "Donated goods, facilities and services, including volunteers" which provides more guidance.

In most cases it is expected to be reasonably obvious to the charity if there is a social donation lease.

Where a charity determines that it is party to a social donation lease, it must consider the nature of the incoming resources as this determines how to measure them. In some cases the incoming resource may be in effect the donation of an asset, whose fair value the charity is able to fully exploit. However, in many cases the incoming resource may be in effect the donation of a service or facility.

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 when the resources are received or receivable. The charity recognises the related income at the same time, assuming there are no performance-related conditions (which are considered unlikely in most lease arrangements). Where performance-related conditions do exist, the charity recognises the income when the performance-related conditions are met. Recognising the income when resources are received or receivable follows the principles for recognising income from non-exchange transactions.

The incoming resources from the non-exchange component forms part of the cost of the right-of-use asset. This increases the value of the asset being included on the charity's balance sheet. As a result, the depreciation charges for the right-of-use asset will be greater than they would otherwise have been if the non-exchange component had not been recognised. The lease liability is the present value of the actual payments due to the lessor subsequent to the commencement date. The initial lease liability may consequently be lower than the initial value of the right-of-use asset.



Example 5.3-5- Accounting for social donation (Public Benefit Entities only)

- ▶ Charity enters into a 5 year office lease on 1 January 20X1
- ▶ Lease payments are due of £50,000 per year, paid on the last day of each year
- ▶ The market rental value of the office is £150,000 per annum.
- ▶ Charity expected to pay £75,000 for an equivalent office elsewhere
- ▶ Donated income is therefore £25,000 pa
- ▶ Charity has calculated an applicable discount rate of 5%
- ▶ Charity has a year end of 31 December
- ▶ Accounted for as an operating lease under current FRS 102.





Under Charities SORP 2019 and FRS 102 2022 the entries would be as follows:

Year	Lease expense	Commitment < 1 year (disclosure only)	Commitment 1-5 years (disclosure only)	Donated services and facilities income and expense
20X1	50,000	50,000	150,000	25,000
20X2	50,000	50,000	100,000	25,000
20X3	50,000	50,000	50,000	25,000
20X4	50,000	50,000	-	25,000
20X5	50,000	-	-	25,000

Current FRS 102

Year ended	Lease expense	Commitment < 1 year (disclosure only)	Commitment 1-5 years (disclosure only)	Donated services and facilities income and expense
31 Dec 2026	50,000	50,000	150,000	25,000
31 Dec 2026	50,000	50,000	100,000	25,000
31 Dec 2026	50,000	50,000	50,000	25,000
31 Dec 2026	50,000	50,000	-	25,000
31 Dec 2026	50,000	-	-	25,000

Under FRS 102 SORP 2026 for charities, the social donation of £125,000 is recognised as donated income at the commencement of the lease and is included as part of the value of the right-of-use asset.

The asset continues to be depreciated over its useful life, albeit that it has a higher value than where there is no social donation element. As a result, the entries to income and expense do not match until both the liability is unwound and the asset is fully depreciated.





Comparison of expenses versus current SORP

Year	Depreciation expense	Interest expense	Total expense (FRS 102 2024)	Current FRS 102 2022 lease expense
2026	68,295	10,824	79,119	50,000
2027	68,295	8,865	77,160	50,000
2028	68,295	6,808	75,103	50,000
2029	68,295	4,649	72,944	50,000
2030	68,295	2,381	70,676	50,000
Total			375,000 (rounded)	250,000

ROU Asset = Lease liability + Value of social donation (£216,375 + £125,000)

Annual depreciation charge = ROU Asset value / lease term (£341,375 / 5)

Year	Depreciation expense	Interest expense	Total expense (FRS 102 2024)	FRS 102 2022 net lease expense*
20X1	68,295	10,824	79,119	50,000
20X2	68,295	8,865	77,160	50,000
20X3	68,295	6,808	75,103	50,000
20X4	68,295	4,649	72,944	50,000
20X5	68,295	2,381	70,676	50,000
Total			375,000 (rounded)	250,000

*includes £25,000 income and expenditure per year for donated services for the non-exchange component within the lease.

Assessment

Where social donation leases exist there will be implications on the reporting of charity reserves. The value of the right-of-use asset on initial recognition will be greater than the lease liability. Charity total funds will therefore increase as the donated service (gift in kind) will not be equal to the gift in kind expense. This will require careful consideration in terms of reserves reporting and the calculation of income funds that are freely available to spend on any of the charity's purposes.



5.4 Lease Liability – Subsequent Measurement



Interest on the lease liability is recognised in profit or loss, unless it is included in the carrying amount of an asset as required by another standard (e.g. Section 25 Borrowing Costs).

BDO comment

Section 25 Borrowing Costs was consequentially amended to clarify that interest in respect of lease liabilities recognised in accordance with Section 20 Leases are 'borrowing costs'. Therefore, the amount of borrowing costs that are subject to the requirements of Section 25 Borrowing Costs (i.e. potential capitalisation) may increase as a consequence of Section 20 Leases.

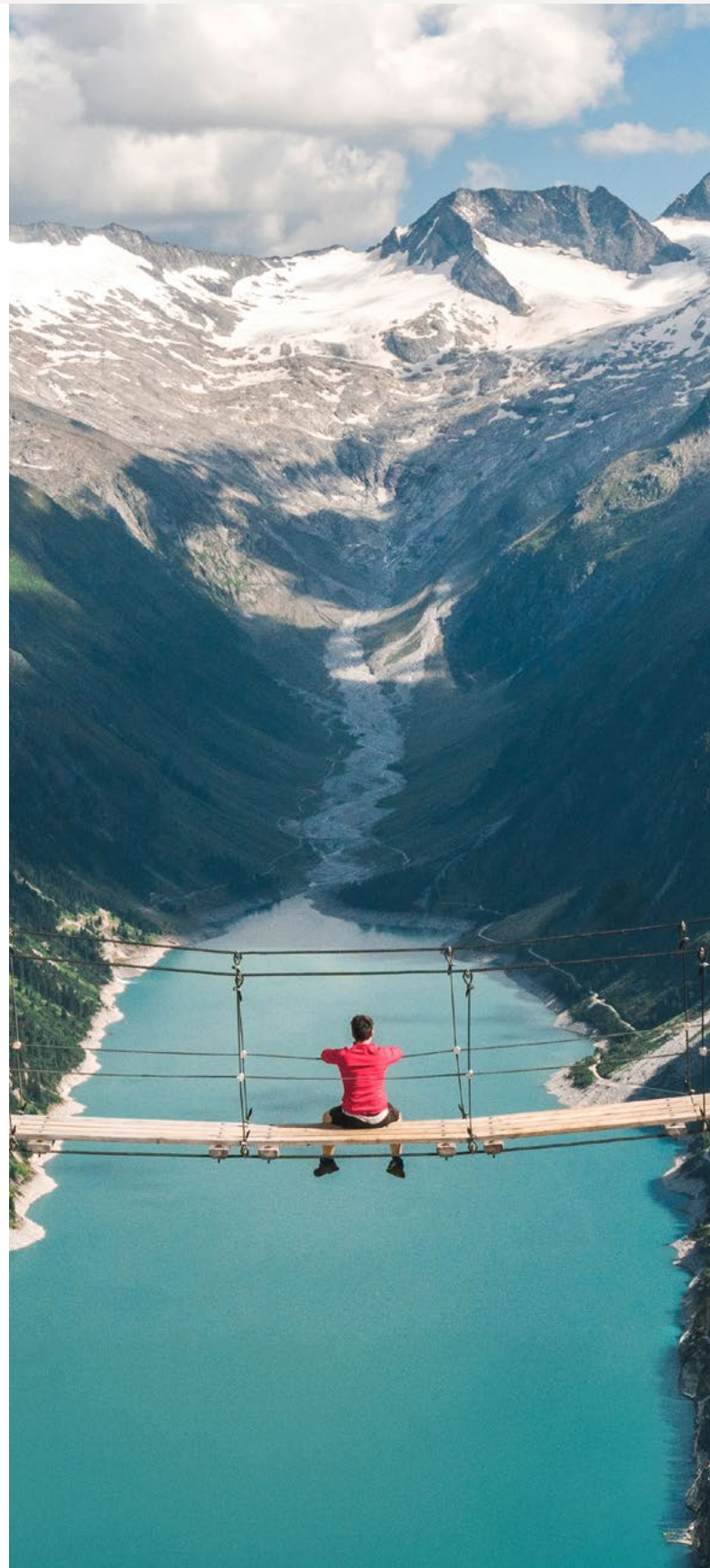
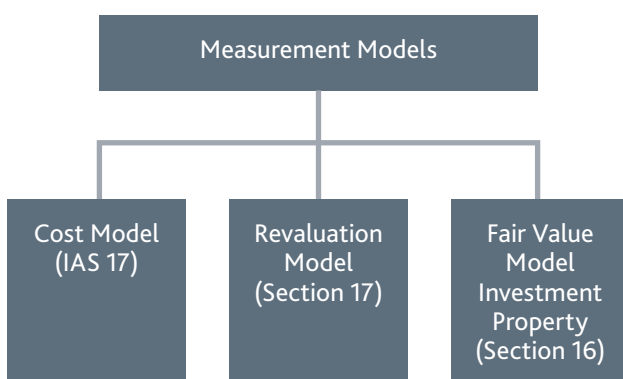
Situations where interest on lease liabilities may be capitalised into the cost of other assets include:

- ▶ the production of inventory;
- ▶ the construction of property, plant and equipment and investment property; and
- ▶ the development of intangible assets.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

5.5 Right-of-Use Asset – Subsequent Measurement

Subsequent to initial recognition, an entity may apply three potential models to account for right-of-use assets:



BDO comment

Section 20 Leases references Section 17 Property, Plant and Equipment and Section 16 Investment Property for guidance on subsequent measurement, but it does not state that the right-of-use asset in a lease contract is property, plant and equipment or investment property.

Section 6 below discusses how right-of-use assets should be presented in the statement of financial position.

Cost Model

Under the cost model, an entity measures a right-of-use asset at:

- ▶ Cost measured in accordance with Chapter 5.3 above;
- ▶ Less accumulated amortisation (recognised in accordance with the depreciation requirements of Section 17 Property, Plant and Equipment) and accumulated impairment losses (recognised in accordance with Section 27 Impairment of Assets);
- ▶ Adjusted for remeasurements (see sections 5.6 and 5.7).

The right-of-use asset is amortised over the lease term (see Chapter 4 above), unless the initial recognition contemplates the exercise of a purchase option or the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. In those cases, the right-of-use asset is amortised over the useful life of the underlying asset.

Example 5.5-1 – Amortisation of a ROU asset when Lease Payments are Initially Variable

Company W is the lessee of retail space for a period of three years and the lease does not contain any extension, termination or purchase options. Lease payments are as follows:

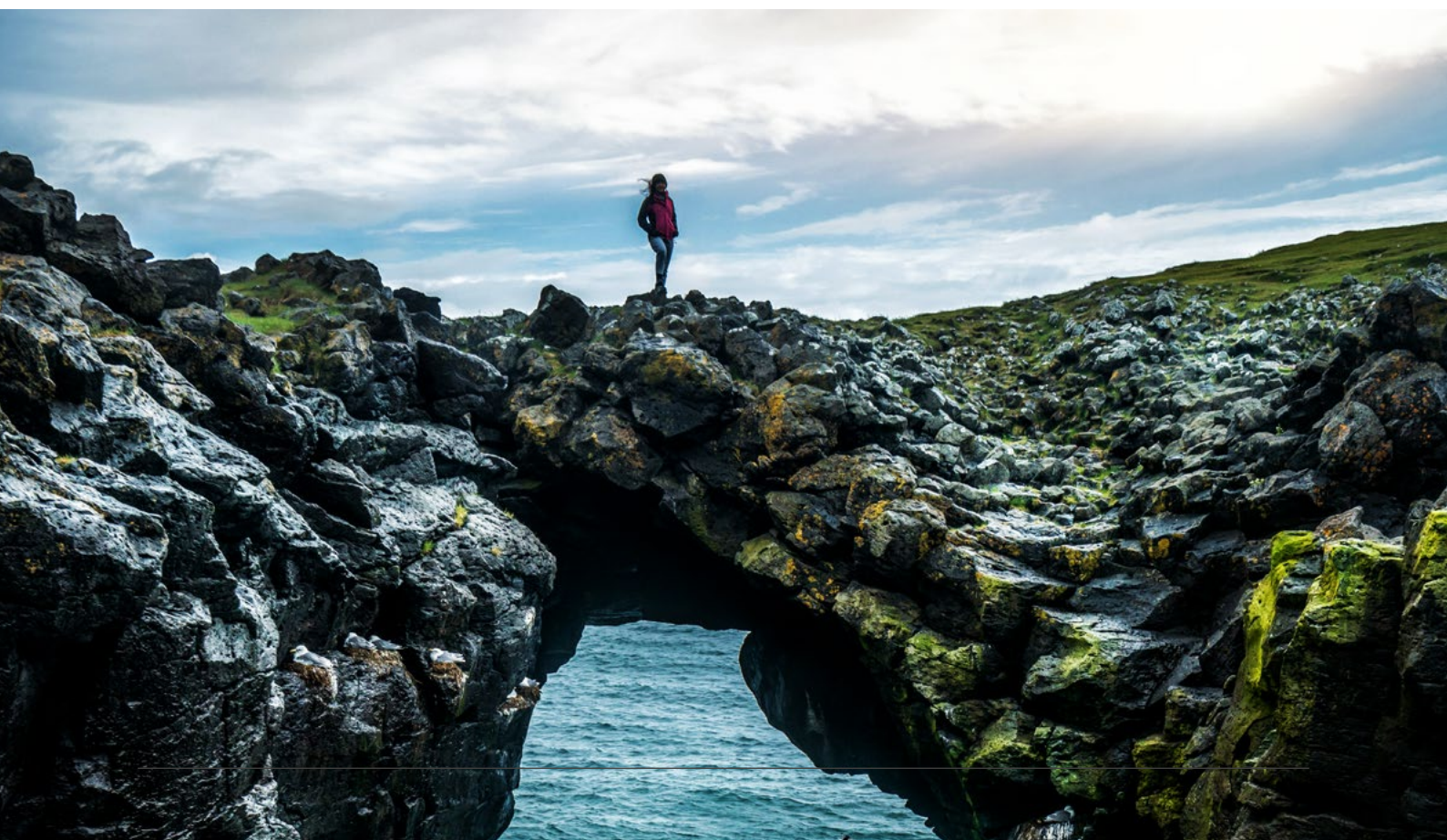
- ▶ Year 1: 5% of the lessee's sales using the retail space;
- ▶ Years two and three: higher of £300 and 5% of the lessee's sales in the year

Ignoring the effect of discounting, Company W recognises a lease liability and right-of-use asset of £600, which represents the contractual minimum to be paid in years two and three (£300 per year). Actual sales are as follows:

- ▶ Year 1: £6,500
- ▶ Year 2: £6,240
- ▶ Year 3: £6,160

Therefore, Company W pays £325, £312 and £308 in each of the years (5% of sales, as this figure exceeds the contractual floor of £300 established in years two and three).

The issue is whether the right-of-use asset of £600 should be amortised on a straight-line basis over the three year term (approach 1 in the table below), or should the depreciation be re-allocated to account for the fact that year one's total expense is 'front loaded' (approach 2 in the table below)?



	Approach 1			Approach 2		
	Variable lease expense	Amortisation	Total	Variable lease expense	Amortisation	Total
Year 1	325	200	525	325	Nil	325
Year 2	12**	200	212	12	300	312
Year 3	8**	200	208	8	300	308
Total	345	600	945	345	600	945

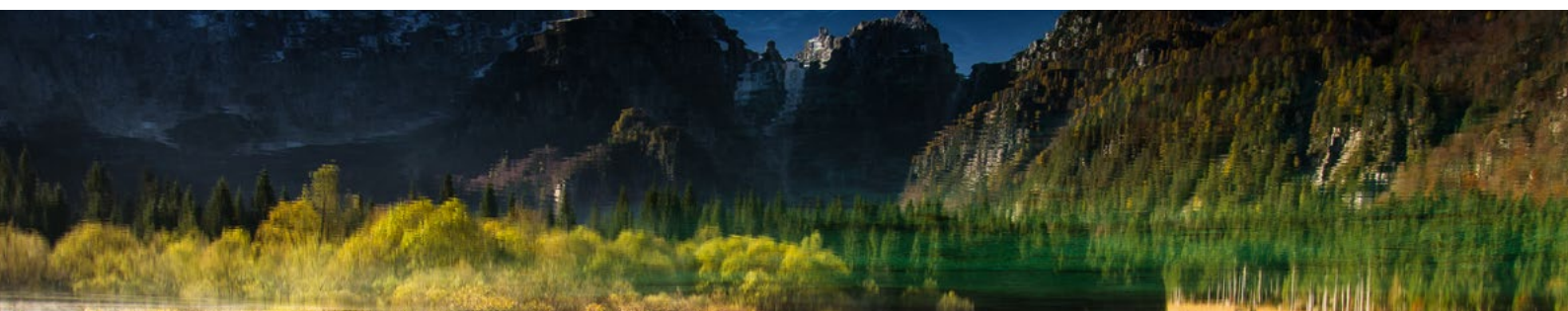
**Only the amount of the payment that exceeds the contractual minimum of £300 is included in profit or loss in the period in which the payment comes due, as the contractual minimum was included in the measurement of the lease as at the commencement date.

In approach 1, the requirements of Section 20 Leases result in the right-of-use asset being amortised on a straight line basis over the three year term. This results in much higher expense in year one, since one third of the total amortisation is recorded in that period in addition to the variable lease amount, since year one's payment is based entirely on a percentage of sales.

In approach 2, since the total expense in year one does not reflect the underlying economics of the transaction (i.e. that the benefit of the retail space in the lease is being consumed evenly), amortisation is modified to 'smooth' the total expense across the periods. Amortisation in year one is set to nil such that the total expense in year one is more in line with approximately one third of the total cash payments expected over the lease term ($£945 / 3 = 315$).

Assessment

Section 20 Leases' requirements relating to the subsequent measurement of right-of-use assets under the cost model are clear that the right-of-use asset is amortised based on the requirements of Section 17 Property, Plant and Equipment, subject to the requirements in FRS 102 20.58. FRS 102 20.58 states that the period of amortisation is the shorter of the lease term and the useful life of the underlying asset, assuming that no reasonably certain to be exercised purchase options exist. As the useful life of the retail space exceeds three years, the amortisation period of the right-of-use asset is three years. There is no conceptual basis for charging reduced amounts in particular reporting periods and reallocating the amortisation expense to different reporting periods in order to achieve a 'smoothing' effect. Therefore, in our view, Company W is required to follow Approach 1.



BDO comment

Componentisation of right-of-use assets

Section 20 Leases directs entities to record amortisation based on the requirements of Section 17 Property, Plant and Equipment, and FRS 102 17.16 requires major components of an item of PPE that has significantly different patterns of consumption of economic benefit be amortised separately. In our view, similar accounting is required for right-of-use assets with significant components when the lessee is required to incur the cost of replacing or maintaining such components. Componentising right-of-use assets into distinct units of account for amortisation purposes

would create significantly different amortisation expense for underlying assets that have differing useful lives for sub-components.

For example, aircraft leases often contain clauses requiring lessees to perform major overhaul and maintenance of aircrafts based on specific increments of time and/or flight hours. If an aircraft lease contained a 10-year lease term, but the engines in the aircraft would require replacement after four years at the cost of the lessee, then the engines should be amortised separately over their four-year useful life. Determining the basis for componentising significant leased assets may require significant judgment.

Timing of commencement of amortisation

Section 20 Leases states that entities apply the guidance of Section 17 Property, Plant and Equipment relating to how ROU assets should be amortised, subject to the requirements of FRS 102 20.58. Lessees may enter into leases that require 'fit out' periods where the underlying asset will take a period of time to be ready for the ultimate intended use by the lessee. For example, a lessee may lease office space where the first few months of the lease are spent installing leasehold improvements and preparing the space to be used by the lessee's employees. The question arises as to whether the lessee would be permitted to defer the commencement of amortisation of the ROU asset until the asset is ready for its intended use, which would be a 'usage based' amortisation model, which is permitted by Section 17 Property, Plant and Equipment in some situations.

In our view, while Section 20 Leases directs entities to Section 17 Property, Plant and Equipment for amortisation requirements, this is still subject to the requirements of paragraph 58 of Section 20 Leases, which states that '...the lessee shall depreciate the right-of-use asset from the commencement date...'. Therefore, the commencement of amortisation cannot be deferred to a period later than the commencement date of the lease. This is because the entity is benefiting from its right to use the underlying asset during the fit out period, regardless of whether the underlying asset is being used for its ultimate intended purpose.

Non-consecutive lease terms and amortisation impact

In amortising the right-of-use asset, special consideration should be made for leases with non-consecutive periods of use. For example, a lessee enters into a lease where it will utilise retail space in a shopping centre for 3 months in each calendar period (i.e. 15 months in total). Based on the initial recognition requirements of Section 20 Leases, the lessee recognises the lease liability and right-of-use asset as at the commencement date of the lease as £150,000. In each period of use (i.e. each 3 month period when the retail space is utilised), the lessee would recognise £10,000 of amortisation expense (150,000 / 15 months of total use). The lessee would not record amortisation expense in the periods when the retail space is not utilised, as FRS 102 17.22 states that the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed. As no economic benefit is consumed in the period when the retail space is not utilised, amortisation is only recorded during the periods of use by the lessee. However, in contrast to the depreciation expense which is based on the periods in which the asset is available for use, the lessee would recognise a finance expense in all months in each calendar year.

Restricted use of lease asset – impact on amortisation

In some situations, use of a leased asset is restricted. In such cases, the right-of-use asset continues to be amortised, as the leased asset is being used, although in a limited way. However, if the use of the leased asset is entirely halted for a certain duration of time, this is considered to be similar to non-consecutive lease terms discussed above and the amortisation of the right-of-use asset is suspended during the period when the use of the leased asset is halted.

For example, during the COVID-19 pandemic, a government passes a law requiring closure of shopping centres for an indefinite period. The rights and obligations under associated lease contracts are suspended for this period. During the period of closure, the lessee cannot carry out any renovation work on the stores or use them as a warehouse for online sales. However, the inventory already in the store will remain there, and does not need to be moved to another storage facility.



FRS 102 17.20 requires that

Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognised. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

In the above example, although the store is not being used to sell goods, it is being used as a warehouse to store goods. Consequently, the store is still being used, albeit in a rather limited way, and the related right of use asset continues to be depreciated.

However, if the lessee had been required to remove all of its inventory during the period of closure, the answer would be different. This is because there would be absolutely no use of the store by the lessee. In that fact pattern, the right-of-use asset is considered to have non-consecutive periods of use and is not depreciated when the lessee is unable to use the underlying asset (the store) at all.

Revaluation Model

If right-of-use assets relate to a class of property, plant and equipment to which an entity applies the revaluation model under Section 17 Property, Plant and Equipment, a lessee may elect to apply the revaluation model to those right-of-use assets. An entity must be consistent in its classification of a class of property, plant and equipment, and right-of-use assets for the purposes of Section 17 Property, Plant and Equipment and Section 20 Leases.

BDO comment

The option to apply the revaluation model for right-of-use assets where the same class of property, plant and equipment is revalued under IAS 16 results in the potential for inconsistency because an entity is not required to apply the revaluation model to those right-of-use assets. Therefore, an entity may have a group of owned assets (e.g. land and/or buildings) to which it applies the revaluation model, whilst applying the cost model to property leases.

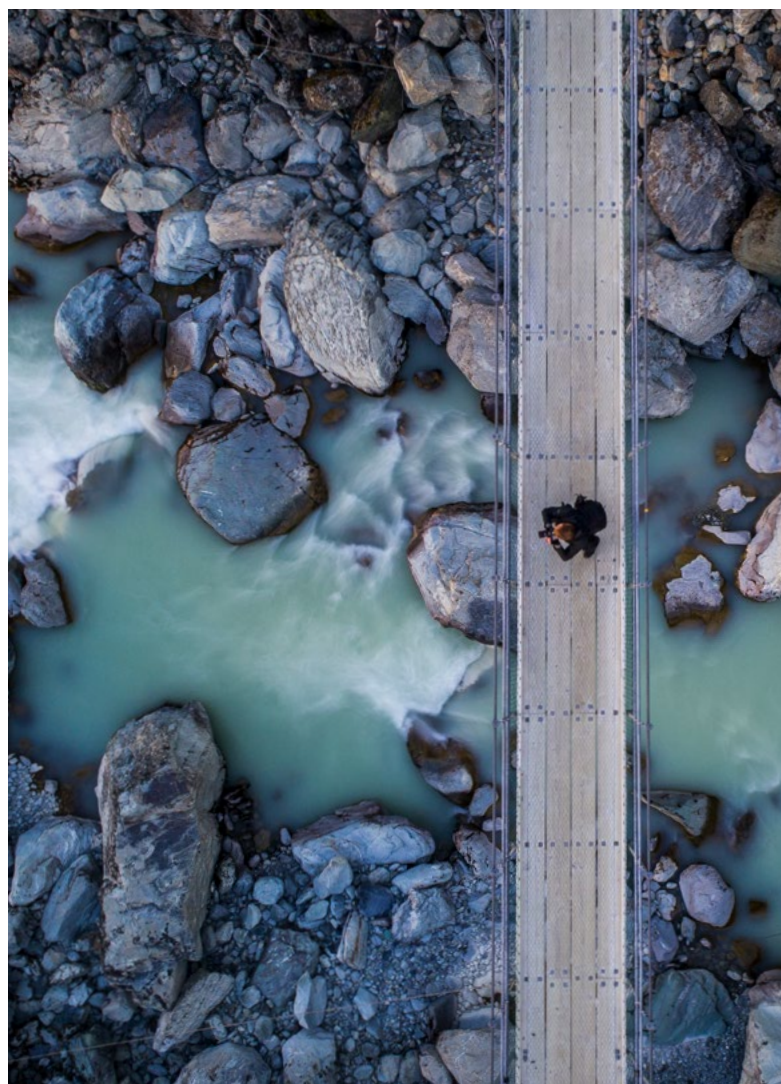
Fair Value Model

An entity applies the fair value model in Section 16 Investment Property to right-of-use assets that meets the definition of investment property, unless the entity applies the exemption in FRS 102 16.4A(b)(ii) where an entity may apply the cost model in its individual financial statements for properties rented to other entities within a group.

Right-of-use assets may meet the definition of investment property in cases where the entity leases a property as a lessee and then sub-leases portions of the property under leases classified as operating from the perspective of the intermediate lessor (e.g. an apartment complex).

Leased Investment Property and Determination of Fair Value when Lease contains Variable Lease Payments not based on an Index or Rate

The initial measurement of a right-of-use asset that meets the definition of investment property is the same as other, non-investment property leases. It is based on the measurement of the lease liability, adjusted for certain items such as initial direct costs, etc. Included in the lease liability are fixed lease payments and variable lease payments based on an index or rate. Variable lease payments not based on an index or rate (e.g. based on a percentage of rental income earned on the underlying property) are excluded. Therefore, if a lease contained only variable lease payments based on a percentage of rental income earned on the underlying property, the right-of-use asset and lease liability would both be measured at zero at initial recognition.



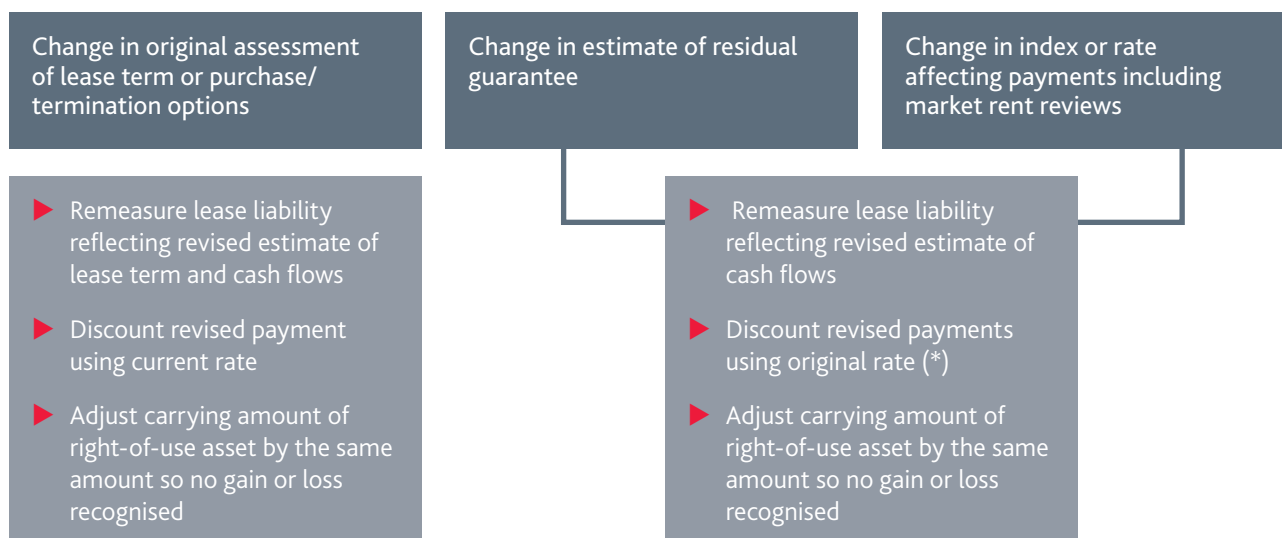
Subsequent to initial recognition of the lease, the lessee is required to measure the right-of-use asset at its fair value. The issue is whether in applying Section 2A Fair Value Measurement to determine the fair value of the right-of-use asset, would a 'day 2' gain be possible since the fair value of the right-of-use asset would consider the variable lease payments that are not based on an index or rate, while the lease liability would not.

In our view, a 'day 2' gain on a right-of-use asset that is classified as an investment property would not be appropriate. While Section 20 specifies that it is the right-of-use asset being measured at fair value (not the underlying property itself), the lessee would typically be unable to transfer the right-of-use asset without also transferring the underlying lease liability. Therefore, in determining the fair value of the right-of-use asset, a market participant would also make assumptions concerning the transfer of any contractual cash flows associated with the lease liability, regardless of whether they are recognised as liabilities in the statement of financial position.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

5.6 Remeasurement of Leases

Lease liabilities and right-of-use assets are remeasured in the following situations:



(*) If the change in lease payments results from a change in floating interest rates, the lessee shall use a revised discount rate that reflects changes in the interest rate. (Refer Example 5.6-7 below – Remeasurement of a lease in case of lease payments that depend on a floating interest rate.)

In most cases of a reassessment the carrying amount of the right-of-use asset is adjusted by the same amount as the adjustment to the carrying value of the lease liability. Therefore, there is no immediate gain or loss; rather the impact of the revised cash flows impacts the income statement over the remaining term of the lease. Exception to this general principle is when a reduction in the carrying value of the lease liability is greater than the carrying value of the related right-of-use-asset at the point of remeasurement, in which case the asset is reduced to nil and the excess is recognised in profit or loss.

Note that prior period figures are not adjusted, with all of these remeasurements being accounted for prospectively.

Example 5.6-1 – Unresolved Rent Review as at Reporting Date – timing of remeasurement

Lessee entered into a three year real estate lease commencing on 1 January 20x1. The lease has a two year extension option, at which time a market rent review takes place. The market rent review modifies the lease payments for years four to five and applies with effect from 1 January 1 20x4 (the first day of the extended period). Rent reviews can take up to 18 months to complete and, as at 31 December 20x4 the rent review for the lease has not yet been completed. The lessee paid the year four rent based on the year three amount, although an adjustment will be required once the rent review is completed in mid 20x5. As at 31 December 20x4, the lessee can make a reliable estimate of the retrospective 'top-up' payment that will be required for 20x4.

The issue is whether the lessee must remeasure the lease liability on the basis of its estimate of the revised rent prior to the rent review occurring, since the effect of the review is retrospective.

Assessment

The lessee should not remeasure the lease prior to the rent review being completed, since FRS 102 20.68(b) states that a lessee is required to remeasure a lease liability if 'there is a change in the future lease payments... including for example a change to reflect changes in market rental rates following a market rent review.' As at 31 December 20x4, the year four and five lease payments have not changed as the rent review has not been completed. Consequently, the lease is not remeasured until the rent review is complete.

Once the rent review is complete, a 'catch up' payment may be required by the lessee for the lease payments made by the lessee while the rent review was ongoing. In our view, such a catch up payment should be reflected as an adjustment to the lease payments. The practical effect of this will be that the lessee would remeasure the lease liability to take into account the revised lease payments once the rent review is completed, including the necessary 'catch up' payment (e.g. DR ROU asset, CR lease liability). The 'catch up' payment necessary would adjust that revised lease liability (e.g. DR lease liability, CR cash).



Example 5.6-2 – Renewal Terms at Negotiated Rental Rates

Lessee Z enters into a 15 year lease of land with fixed payments of £10 million per annum. Lessee Z and the lessor are unrelated parties and are dealing at arm's length.

Lessee Z constructs an apartment building on the land. At the end of the 15 year fixed term, the lease contains a clause that states the lessee can extend the lease for additional five year periods of time, at amounts to be negotiated on each extension date. If the lessee and lessor cannot agree on an amount, arbitration will commence and an independent arbitrator will determine the amount of rental payments based on a market study.

Since Lessee Z has constructed an apartment building on the leased land, it is considered reasonably certain to exercise the options to extend the lease up to a total term of 50 years, which is the useful life of the apartment building.

The issue is whether the yet to be negotiated lease payments are 'variable lease payments based on an index or rate'. The consequence is that if they are, they would be included in the measurement of the lease liability and right-of-use asset.

Assessment

FRS 102 20.53 states that 'variable lease payments that depend on an index or rate' include payments that vary to reflect changes in market rental rates. This is commonly interpreted to include market rent reviews, which are contractual terms that require a market study of a property to be performed in order to determine the revised rental payment.

While Lessee Z's lease does not explicitly require a market rent review to be performed by a third party, Lessee Z and the lessor are unrelated parties dealing at arm's length, and therefore have no realistic alternative but to negotiate what would be considered a 'market rent'. Negotiations between the parties would inherently reflect changes in market rental rates.

Therefore, Lessee Z's lease of land has a lease term of 50 years, consisting of:

1. 15 year initial, non-cancellable term; plus
2. 35 years of reasonably certain to be exercised lessee extension options up until the end of year 50 (these lease extension options are reasonably certain to be exercised as Lessee Z has invested significant amounts into building an investment property on the land).

Lease payments included in the initial measurement of the lease as of the commencement date include 15 years of £10 million payments, plus another 35 years of £10million payments ('variable payments based on an index or rate'). The 35 years of payments under the reasonably certain to be exercised extension options will be remeasured each year from years 15-50 as the annual renewals are renegotiated between Lessee Z and the lessor.



Example 5.6-3 – Timing of Remeasurement of Leases with Variable Lease Payments based on an Index or Rate

Lessee W enters into a lease for a five-year term with a lessor for a retail building, commencing on 1 January. Lease payments are payable annually in advance (i.e. at the beginning of the year, 1 January). The lease contract states that lease payments will increase each year on the basis of the increase in the CPI from the period 1 December – 30 November. The updated CPI is published on 15 December. That is to say, at the beginning of each calendar year, the lessee makes a payment based on the reference amount stated in the lease contract, adjusted by the movement in the CPI from 1 December – 30 November of the previous year.

The issue is whether the lessee should remeasure the lease liability for years 2-5 on 15 December of year one since all variability for year two has been resolved at that point, as the CPI index affecting the lease payments were published on 15 December. Alternatively, should the Lessee remeasure the lease on 1 January of year two, which is the point at which the cash flow change takes effect (i.e. the revised payment is made to the lessor)? FRS 102 20.68(b) states that the lessee remeasures the lease liability to reflect revised lease payments only when there is a change in the cash flows (i.e. when the adjustment to the lease payments take effect), therefore, the issue is how one should interpret when the adjustment has 'taken effect'.

Assessment

The change in payments for year two take effect when all variability relating to them is resolved; at this point they become in-substance fixed. As the revised payment that will be made on 1 January for year two is known once the CPI index is published on 15 December, the revised payment has 'taken effect' on 15 December. If the revised payment were not known until after the balance sheet date (i.e. payments were based on a calendar year CPI movement, which is published on 15 January of the following year), then it would not be appropriate to remeasure the lease liability until the applicable rate is published, as the revised lease payments would not have been known as of the reporting period year-end. That is to say, the revised lease payments would not have 'taken effect' in that case.

Remeasuring lease liabilities based on indices or rates published subsequent to the balance sheet date could result in two entities with identical leases reporting different lease liabilities depending on when they issue their financial statements, which we do not believe is consistent with the objective of Section 20 Leases. Therefore, in our view, the condition required to remeasure the lease liability is that the revised lease payment must be known before the lease can be remeasured.

Example 5.6-4 – Effect of Multiple Rent Reviews within a Single Lease

Lessee enters into a 15-year lease for office space. The payments at the commencement of the lease are set at £10,000 per annum (the current market rent). Market rent reviews occur twice throughout the term of the lease at the start of years 6 and 11. Based on these rent reviews, the rental payment may increase or decrease.

For initial measurement of the lease liability, the lessee uses the current market rent of £10,000 for 15 years (FRS 102 20.51(b) – variable lease payments that depend on an index or rate as at the commencement date of the lease).

The rent included in the liability is adjusted only when the market rent review occurs (i.e. when the adjustment to the lease payments takes effect).

The market rent at the start of year six, at the time of the first review, is £13,000. The rent review at year six means that the variability has been resolved for years 6-10 and so these cash flows will be updated in the liability calculation, consistent with the remeasurement requirements of Section 20 Leases.

The cash flows for years 11-15 remain variable – they will not become known until the market rent review in year 11.

The measurement issue is whether years 11-15 are based on the original assumption of £10,000 per annum in lease payments, or the revised market rate of £13,000 per annum.

Assessment

In our view, at the time of remeasurement in year six, all remaining years in the lease should be remeasured based on the revised £13,000 payment, including years 11-15. In remeasuring a lease, FRS 102 20.68(b) states that ‘a lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments (emphasis added), therefore, all remaining payments should reflect this revision to the lease payments based on the market rent review.



Example 5.6-5 – Effect of Multiple Rates or Indices Affecting Lease Payments

A lessee enters into a 10-year lease. The initial payments are £10,000 per annum, which is the current market rent. There is a market rent review at the start of year six. In other years, the payments increase based on changes in the Consumer Price Index (CPI) in the preceding year.

There is no floor on either the CPI changes or the market rent reviews.

To summarise, the payments are:

Year(s)	Payments
1	£10,000
2-5	£10,000 adjusted for CPI changes since the start of year one
6	Market rent at the start of year six
7-10	Market rent at the start of year six adjusted for CPI changes since the start of year six

For initial measurement of the lease liability, the lessee uses the current market rent of £10,000 for 10 years.

Assume that CPI increases by 3% in the first year and therefore the payment for year two will be £10,300.


Consistent with Example 5.6-4, the cash flows for years two to five will be updated to £10,300 to reflect the revised cash flows.

The cash flows for years 6-10 remain variable since they will not become known until the market rent review occurs in year six.

The measurement issue is whether at the time of the remeasurement in year two, should the lessee assume the payments in years 6-10 should be calculated as £10,300 per annum since additional variability exists due to the eventual market rental review to occur in year six.

Assessment

In our view, at the time of the remeasurement in year two due to CPI changes, all remaining nine years of payments should be calculated as £10,300, the base payment using the revised CPI rate. For the same rationale as discussed in Example 5.6-4, when a remeasurement occurs, FRS 102 20.68(b) states that it is required to be based on the revised contractual payments. The fact that multiple drivers of variability exist in the lease contract does not remove this requirement.

 **Example 5.6-6 – Remeasurement of a Lease due to Reassessment of an Option**

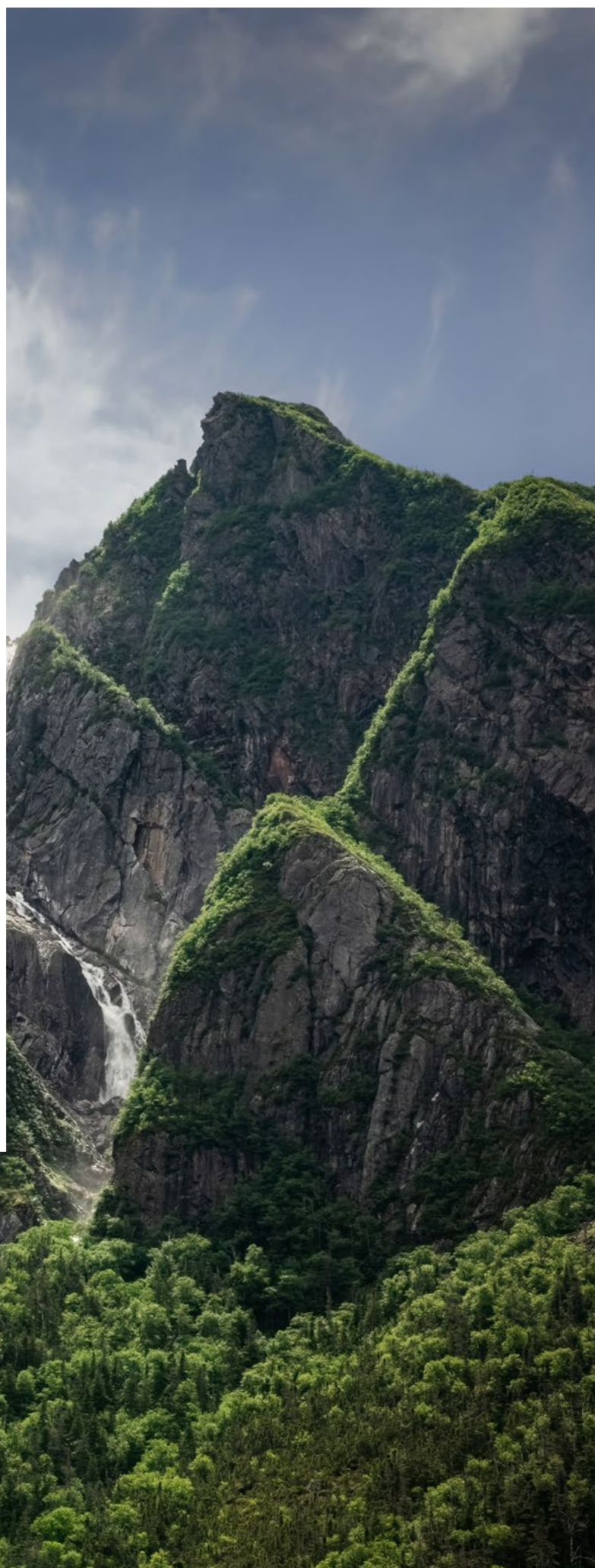
Entity B entered into a 10 year property lease, with an option to renew for another five years. On initial recognition of the lease Entity B was not reasonably certain that it would exercise this option and so the lease term was estimated as 10 years. At the end of year six of the lease Entity B acquires Entity A. Following the acquisition of Entity A, Entity B determines that it would be more cost effective to relocate Entity A's staff and remain in its current premises for longer than the originally assessed 10 year period.


Assessment

Moving Entity A's staff to the same building occupied by the Lessee creates an economic incentive for Entity B to extend its original lease at the end of the non cancellable period of 10 years.

Consequently, at the end of Year six, Entity B concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A's staff. The remaining lease term is revised to nine years (i.e. the period from the end of year six to the end of year 15) and so Entity B remeasures its lease liability to reflect nine years of future lease payments discounted at its incremental borrowing rate at that date (assuming the interest rate implicit in the lease is not readily determinable). The resulting increase in the carrying amount of the lease liability is added to the right-of-use asset. The revised carrying amount of the right-of-use asset is then depreciated over the revised remaining lease term of nine years.

It should be noted that the circumstances above that resulted in the remeasurement of the lease liability and the right-of-use asset did not arise from any modification to the contractual terms agreed between the lessor and the lessee. Instead they arose from revisions to estimates and judgements made on the initial recognition of the lease. The accounting for lease modifications is addressed in Chapter 5.7.



 **Example 5.6-7 – Remeasurement of a lease where lease payments depend on a floating interest rate**

Entity D enters into a lease of a property for five years on 1 January 20X1. The lease payments are payable annually in advance. The lease payment for the first year is £100,000. The lease payments escalate every year at the rate of 12-month EURIBOR at the beginning of the year.

The interest rates for the first two years are as below:

	12-month EURIBOR	Incremental borrowing rate
1 January 20X1	4%	6%
1 January 20X2	5%	7%

The rate implicit in the lease is not readily determinable.

Assessment

The lease agreement provides for escalation in lease payments based on the index rate (12-month EURIBOR). Therefore, these variable lease payments will be included in the measurement of lease liability.

At the commencement of the lease, the lease liability is measured at the present value of variable lease payments using the index at the commencement date i.e. the 12-month EURIBOR on 1 January 20X1. The present value is calculated using Entity D's incremental borrowing rate as on 1 January 20X1 as below:

Date	Lease payment (£)	Discounting factor @ 6%	Present value (£)
1 January 20X1	100,000	1.00	100,000
1 January 20X2	$100,000 * (1.04) = 104,000$	0.94	98,113
1 January 20X3	$104,000 * (1.04) = 108,160$	0.89	96,262
1 January 20X4	$108,160 * (1.04) = 112,486$	0.84	94,446
1 January 20X5	$112,486 * (1.04) = 116,986$	0.79	92,664
	Lease liability		481,485

At the beginning of year two, the 12-month EURIBOR is 5%. The lease liability needs to be remeasured as per the revised index rate. As the change in lease liability results from a change in floating interest rates, a revised discount rate needs to be used for remeasurement of lease liability.

The lease liability will be remeasured on 1 January 20X2 considering the lease payments based on the index on the date of remeasurement discounted at the incremental borrowing rate (7%) at the remeasurement date, as below:

Date	Lease payment (£)	Discounting factor @ 7%	Present value (£)
1 January 20X2	$100,000 * (1.05) = 105,000$	1.00	105,000
1 January 20X3	$105,000 * (1.05) = 110,250$	0.93	103,037
1 January 20X4	$110,250 * (1.05) = 115,763$	0.87	101,111
1 January 20X5	$115,763 * (1.05) = 121,551$	0.82	99,222
	Lease liability		408,370

The lease liability before remeasurement is £404,374, being the opening liability of £481,485 less lease payment of £100,000 as on 1 January 20X1 plus interest accretion @ 6% on £381,485 of £22,889.

The difference between the lease liability before remeasurement of £404,374 and the remeasured lease liability of £408,370 amounting to £3,997 will adjust the carrying amount of the right-of-use asset.



**Example 5.6-8 – Lessee's accounting for termination penalties paid by the lessor**

Lessee enters into a five-year lease for 2,000 square metres of office space. The annual lease payments are £100,000 payable at the end of each year. The lease contract includes a termination option with a penalty that is exercisable at the option of Lessor during year two. The termination option includes a notification period of one year such that, once exercised, the lease contract will terminate in year three. The termination penalty is £40,000 and is payable in year three. As only the lessor has the right to terminate the lease, the lease term is determined to be five years at inception.

At the beginning of Year two, the lessor exercised the option to terminate the lease.

Assessment

In our view, the adjustment of the lease term and the payment due from the Lessor should be accounted for as adjustments to the right-of-use asset and the lease liability. At the time the termination notice is received by the Lessee, £100,000 of payments remain (the year three lease payment). Lessee would adjust the lease liability to include the receipt of the lessor's termination penalty at the end of year three (£100,000 – £40,000 = £60,000 net payments remaining) and discount this net amount using a newly determined discount rate. The offsetting effect of this adjustment would be recorded against the right-of-use asset, with any excess being recorded in profit or loss.

This accounting achieves the same effect as if the Lessor's penalty was in the form of an adjustment to the remaining lease payment of £40,000. If this had been the case, using Section 20 Leases' remeasurement accounting model would be clear as the remaining lease payments had been modified by the exercising of the Lessor option. The underlying economics of the two variations of case facts are identical; therefore, we consider that there should be similar accounting outcomes.

**Example 5.6-9 – Remeasurement of lease liability in case of surrender premium**

A lessee and lessor enter into a lease for office space. The lease payments are fixed and due each month in advance.

The lease agreement contains a break clause that provides the lessee with an option to terminate the lease early with 3 months' notice if a surrender premium is paid. The surrender premium is a fixed amount of cash payable upon exercising the option. Once the option is exercised, only the surrender premium and 3 months of lease payments are payable. Both the lessee and the lessor consider that

the break clause is not reasonably certain to be exercised. The lease term, as determined at the commencement of the lease, is 10 years, which is the non-cancellable period, assuming the break clause will not be exercised.

The lessee accounts for the right-of-use asset using the cost model (refer Chapter 5.5 for guidance on subsequent measurement of right-of-use assets) and the lessor classifies the lease as an operating lease.

At the beginning of year six, the lessee experiences significant financial difficulty and, as a result, the lessee reassesses its business plan and exercises the break clause.

Assessment**Lessee accounting**

As at the commencement of the lease, the lease liability is initially measured at the present value of the 10 years of fixed lease payments. As the break clause is not considered reasonably certain to be exercised, the period covered by the break clause is included in the lease term.

At the beginning of year six, the lessee is required to reassess whether it is reasonably certain to exercise the termination option. This is required because the change in business plan caused by the significant financial difficulty is a significant event or change in circumstance that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise the break clause.

Upon the reassessment of the lease term, the lessee is required to determine the revised lease payments. The revised lease payments would consist of the exercise price of the surrender premium that is payable upon the break clause being exercised and 3 months of remaining lease payments.

The lease liability would then be adjusted to reflect the revised payments, discounted using a revised discount rate, with the offsetting entry being recognised as an adjustment to the ROU asset. If the carrying amount of the ROU asset was reduced to zero by this remeasurement and there was a further reduction in the measurement of the lease liability, that further reduction would be recognised in profit or loss.

Note that the reassessment of the lease term and the resulting remeasurement may occur earlier than the date on which the break clause is exercised. For example, if at the end of year five the lessee considered that it was reasonably certain to exercise the break clause in year six of the lease based on its revised business plan, then the lessee would be required to reassess the lease term at that time and remeasure the lease.

Lessor accounting (refer to section 8 for lessor accounting)

As at the commencement of the lease, the lessor would recognise operating lease income on a straight-line or another systematic basis (if appropriate). The period of time over which operating lease income is recognised would be the lease term as determined as at commencement i.e. 10 years.

FRS 102 20.43 requires only lessees (not lessors) to reassess lease options upon the occurrence of a significant event or significant change in circumstances, therefore, it does not apply to lessors.

FRS 102 20.44 requires an entity (i.e. both lessees and lessors) to revise the lease term if there is a change in the non-cancellable period of a lease, which includes, for example, a lessee exercising an option not previously included in the entity's determination of the lease term (FRS 102 20.44).

Therefore, when the break clause is exercised, the lessor is required to reassess the lease term and the total consideration included in the operating lease accounting. The operating lease is accounted for using the revised lease term and payments on a prospective basis.

To illustrate, if the original lease consisted of monthly payments of £100 over the 10-year lease term, the lessor would recognise £100 per month as operating lease income, assuming no initial direct costs.

If at the beginning of year six, the break clause was exercised, with a surrender premium of £1,000 becoming payable to the lessor, then the lessor would account for the revised remaining consideration of £1,300 (£1,000 surrender premium plus 3 months of remaining lease payments) over the revised remaining lease term (3 months). Therefore, £433.33 (£1,300 / 3 months) would be recognised as operating lease income over the remaining 3 months of the lease.

Example 5.6-10 – Remeasurement of lease due to lessor exercising termination option

Lessor and lessee signed a lease for 10 years with a break clause effective on the last day of the fifth year. The break clause could be exercised by either party with at least one year's notice.

The property was to be used by the lessee as its head office. The lessee invested in leasehold improvements with an estimated useful life of 10 years.

The lessee initially assesses the lease term as being 10 years because the lessee assesses that it is reasonably certain not to exercise its option to terminate. The

lessee ignores the lessor termination option in determining the lease term (see Chapter 4.2.1.1).

At the end of year four, the lessor gives notice to terminate the lease at end of year five. Immediately before this occurs, the lessee would have recognised a lease liability for 6 years of additional lease payments, however, the lessee now has certainty that it will only owe 1 further years' worth of payments.

The issue is whether the lessee should recognise the lessor's exercising of the forward-starting termination option at the end of year four, or only when the termination option is effective (i.e. at the end of year five).

Assessment

With the exercise of its option to terminate the lessor has removed the lessee's implied option to use the property beyond year five. Without such an option, the lease term cannot go beyond year five. Furthermore, without re-measurement, the carrying value of the asset will no longer reflect the period over which economic benefit cannot be expected to arise.

In our view, the lessee must reassess the lease term at the end of year four as there is a change in the non-cancellable period of the lease FRS 102 20.44 and remeasure the lease liability and ROU asset. As required by FRS 102 20.66(a), the lessee would remeasure the lease liability using a revised discount rate.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.



5.7 Lease Modifications

Lease modifications arise from changes to the underlying contract agreed between the lessee and the lessor subsequent to commencement of the lease.

FRS 102 Glossary defines a lease modification as:

A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

In assessing whether there has been a change in the consideration for a lease, an entity considers the overall effect of any change in the lease payments. For example, if a lessee does not make lease payments for a three-month period, the lease payments for periods thereafter may be increased proportionally in a way that means that the consideration for the lease is unchanged.

If there is no change in either the scope of the lease or the consideration for the lease, then there is no lease modification.

If there has been a change in either the scope of or the consideration for the lease, an entity next considers whether that change was part of the original terms and conditions of the lease. The entity is also required to consider all relevant facts and circumstances, which may include contract, statutory or other law or regulation applicable to lease contracts. Changes to lease payments that result from clauses in the original contract or in applicable law or regulation are part of the original terms and conditions of the lease, even if the effect of those clauses was not previously contemplated. Such changes are not lease modifications for the purpose of Section 20 Leases.

Accounting for lease modifications

The accounting for the modification depends on whether the modified terms increase or decrease the scope of the lease, and whether increases in scope require consideration to be paid that is commensurate with a 'standalone price' for the new scope of the lease.

BDO Comment

Judgement must be applied to assess whether the extension of lease terms between existing parties are treated as new leases or the modification of the original lease. For example, consider a lease that does not include any renewal option. During the lease term, the parties enter into a new lease for the same identified asset that commences when the original lease ends. This change is not accounted for as a separate lease as

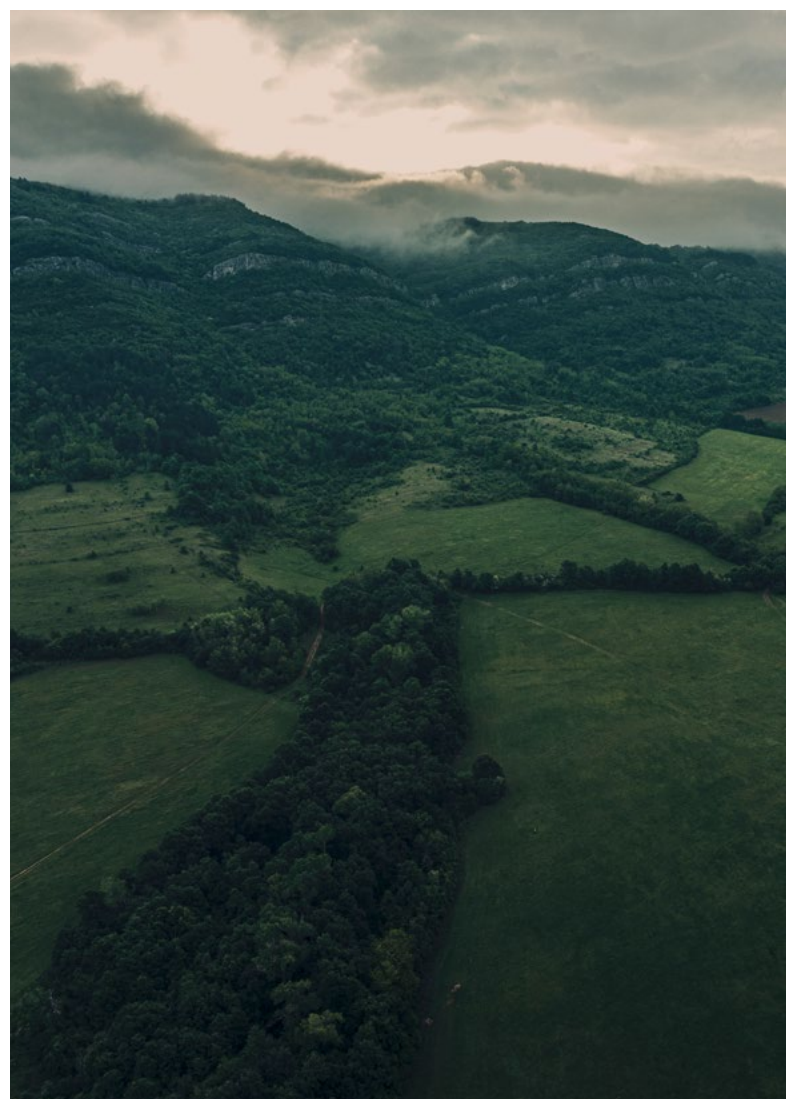
it does not convey the right to use additional underlying assets; the asset in question is the same. In our view, this would be accounted for as a lease modification which would be accounted for at the date on which the agreement between the lessee and the lessor is modified. The remeasurement would not be delayed until the end of the term on the original underlying lease since, in substance, this is a modification to the contractual terms of the original lease.

Modifications - Separate Leases

A lease modification is accounted for as a separate lease if:

- ▶ The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- ▶ The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

If both criteria are met, a lessee would follow the previous guidance in this publication on the initial recognition and measurement of lease liabilities and right-of-use assets.





Example 5.7-1 – Lease Modification that is a Separate Lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year six, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year six. The increase in total consideration for the lease modification is commensurate with the current market rate for 3,000 square metres of office space, except for a discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

Assessment

Lessee accounts for the modification as a separate lease, i.e. separately from the original 10-year lease, the accounting for which is unaffected by the lease modification. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the new right is commensurate with its stand-alone price. In this example, the additional right-of-use asset is the extra 3,000 square metres of office space for three and a half years. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year six), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space for three and a half years. Lessee does not make any adjustments to the right-of-use asset or lease liability relating to the original lease of 2,000 square metres of office space which continue to be accounted for as if there had been no modification.



BDO comment

The legal form of a lease agreement may be modified to add additional assets (e.g. additional floors of an office building). In cases where the additional right-of-use assets are added to the contract at a price commensurate with their standalone price, the modification is in substance a new lease contract and the modification is accounted for as a separate lease under FRS 102 20.70.



BDO comment

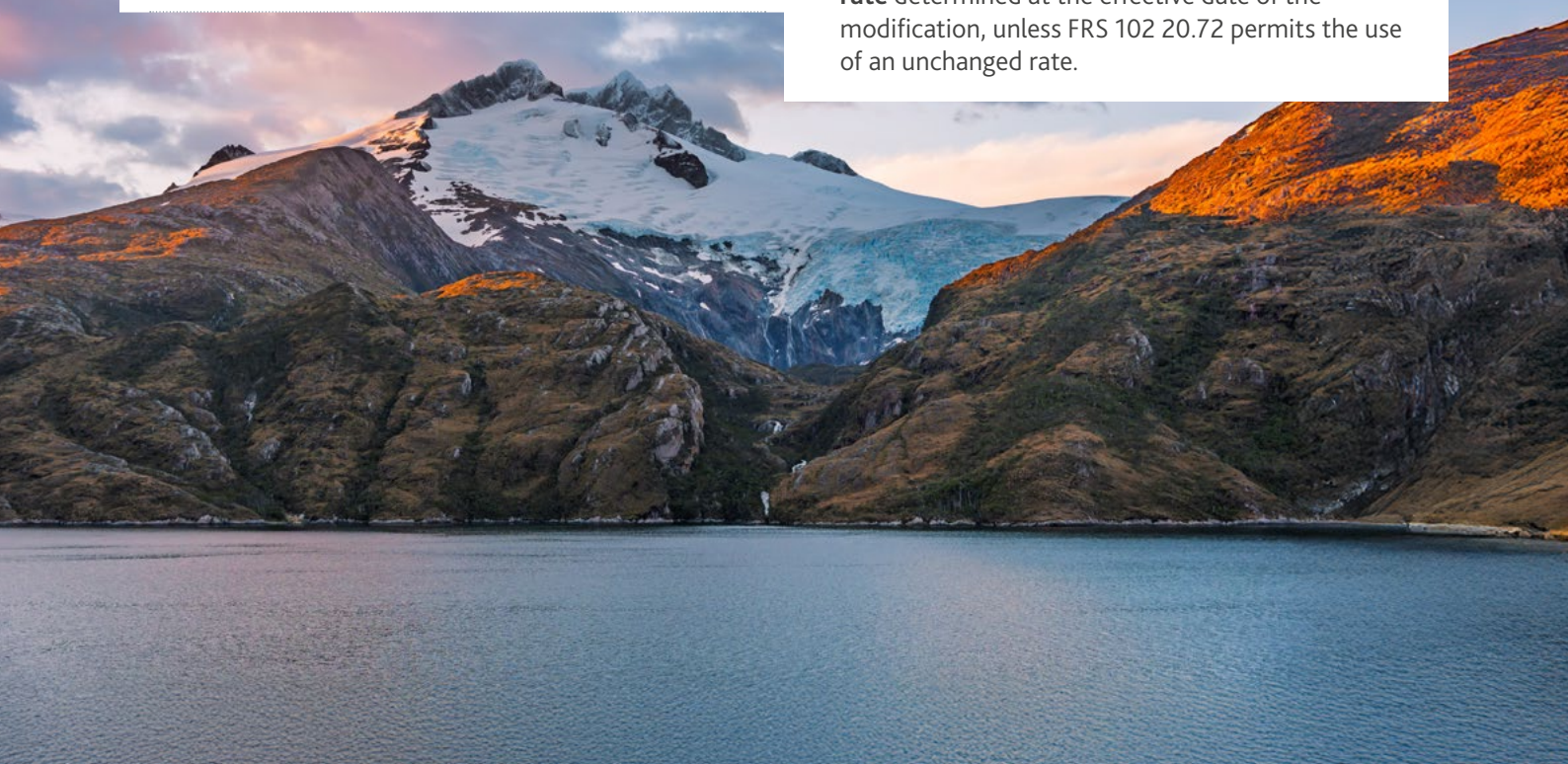
There may be situations when there is a change in the lessor e.g. when a property is sold by the current lessor and the lease is transferred to the buyer on existing terms and conditions. In such cases, where there is a change only in the counterparty, the change is not treated as a termination of the existing lease and commencement of a new lease. The lessee will continue the accounting for the existing lease.

Modifications – Not Separate Leases

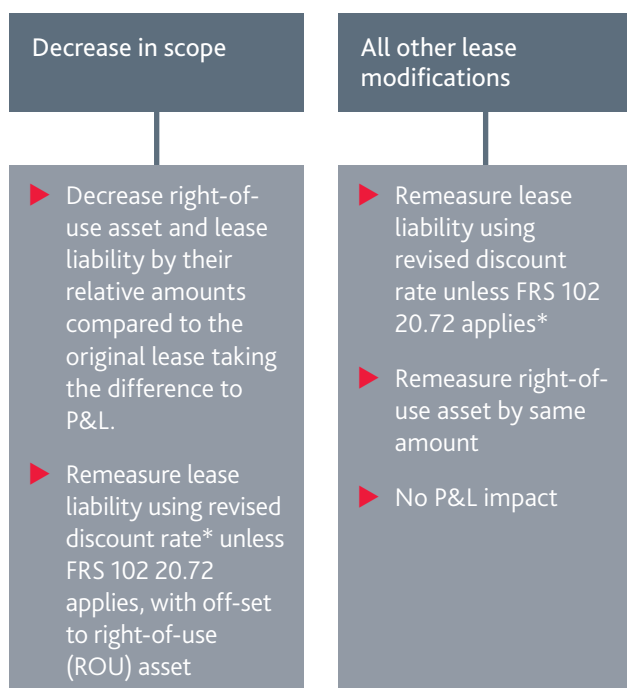
If a lease modification does **not** meet both criteria to be accounted for as a separate lease in FRS 102 20.70, the lessee applies **FRS 102 20.71** at the **effective date of the modification**.

The lessee:

1. **Reallocates the consideration** in the modified contract
2. **Reassesses the lease term**, applying
3. **Remeasures the lease liability** by discounting the revised lease payments using a **revised discount rate** determined at the effective date of the modification, unless FRS 102 20.72 permits the use of an unchanged rate.



The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:



* The prevailing incremental borrowing rate or obtainable borrowing rate at date of modification is used unless the implicit rate in the lease is readily determinable or relief in FRS 102 20.72 applies.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

If a lease modification results in the lessee obtaining additional rights to use one or more underlying assets, but not at an amount that is commensurate with the standalone price for the increase in scope, the liability is remeasured by discounting all of the future lease payments as revised in the modified contract at the lessee's incremental or obtainable borrowing rate at the date of modification (assuming the rate inherent in the lease is not readily determinable). It does not use the discount rate that applied to the pre-modified lease payments. The remeasurement of the lease liability is adjusted against the carrying value of the right-of-use asset such that no gain or loss arises as a result of the modification. The same accounting is applied if the term of the original lease is extended without adding any additional rights to use any more underlying assets.



Example 5.7-2 – Lease Modification that Increases the Lease Term

Entity A has a 10-year lease on 5,000 square metres of office space with annual payments of £100,000 payable at the end of each year. The rate used to discount the payments is Entity A's incremental borrowing rate of 6% which Entity A has elected to use (the rate implicit in the lease is not readily determinable). At the beginning of year seven, Entity A and the lessor amend the lease by extending it for an additional four years. The annual payments remain unchanged. At the beginning of year seven, Entity A's incremental borrowing rate is 7%.

Assessment

The modification is not accounted for as a new lease as it does not convey the right to use any additional assets. The lease is for the same underlying property.

Therefore, the lease is remeasured using a revised discount rate (i.e. the incremental or obtainable borrowing rate at the time of the modification; not the original discount rate).

The lease liability immediately prior to the modification is £346,511.

Present value of years 7 – 14 (8 years), £100,000 a year, 7% discount = £597,130

$$\begin{aligned}
 \text{Adjustment required} &= \text{newly remeasured liability} \\
 &\quad - \text{previous carrying value of liability} \\
 &= £597,130 - £346,511 \\
 &= £250,619
 \end{aligned}$$

Entry required as a result of the modification:

DR right-of-use asset	250,619
CR lease liability	250,619

If the modification results in a decrease in scope (e.g. reducing the amount of asset(s) that are being leased) and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope the accounting is more complex. The resulting liability may be measured in the same way as above by discounting the lease payments in the modified contract using an unchanged incremental or obtainable borrowing rate (if the rate implicit in the lease is still not readily determinable), this adjustment is undertaken in two steps:

- ▶ Step 1: the carrying amount of the right-of-use asset at the date of modification is reduced to reflect the partial or full termination on the lease, with an equivalent adjustment being made to the lease liability. If there is a reduction in the scope of the

asset being leased (for example, a reduction in the area being leased from 5,000 square metres to 2,000 square metres), then the proportionate reduction in the right-of-use asset and lease liability will be the same amount (see Example 5.7-3(a)). If there is a reduction in the lease term, the proportionate change in the right-of-use asset will be different from the proportionate change in the lease liability, because of the effect of discounting the future lease payments that have been eliminated (see Example 5.7-3(b)). The difference between the carrying amount of the right-of-use asset and lease liability derecognised gives rise to a gain or loss.

- ▶ Step 2: the carrying amount of the liability resulting from step 1 is adjusted again to ensure its carrying amount equals the future lease payments in the modified contract discounted using an unchanged incremental borrowing or obtainable rate at the modification date. This second adjustment to the lease liability is accounted for by making a corresponding adjustment to the right-of-use asset. No gain or loss is recognised in this step.



Example 5.7-3(a)(i) – Lease Modification that Decreases Scope using a revised discount rate

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of £50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable and Entity B has elected to use its incremental rate rather than its obtainable rate. At the beginning of year six Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to £30,000 a year. At the beginning of year six, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is £210,618 and the right-of-use asset is £184,002.

The scope of the decrease in the right-of-use asset is 50%, as the leased space has decreased from 5,000 square metres to 2,500.

Present value of years 6 – 10 (5 years), £30,000 a year, 5% discount = 129,884

Entry required to adjust the carrying balances to reduce scope (step 1):

DR lease liability	105,309	(210,618 original * 50%)
CR right-of-use asset	92,001	(184,002 original * 50%)
CR gain	13,308	(remainder)

Entry required to adjust lease liability to the required revised balance of £129,884 (step 2):

DR right-of-use asset	24,575	(corresponds to liability adjustment)
CR lease liability	24,575	(£210,618 - £105,309 + £24,575 = £129,884)

Entity B uses the revised discount rate of 5% as the decrease in scope is not commensurate to the decrease in consideration. Under the original lease agreement, the annual payment equated to **£10 per square metre** (£50,000 ÷ 5,000 square metres). Following the modification, the revised consideration equates to **£12 per square metre** (£30,000 ÷ 2,500 square metres). Based on current market conditions, Entity B concludes that the reduction in payments of £20,000 per annum is not commensurate with the stand-alone selling price of the decrease in scope of 2,500 square metres.

If, alternatively, Entity B had concluded that the decrease in scope of the lease resulted in a decrease in the consideration payable by an amount commensurate with the stand-alone price for the decrease in scope then a revised discount rate would not be used.



Example 5.7-3(a)(ii) – Lease Modification that Decreases Scope using an unchanged discount rate

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of £50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 3% as the rate implicit in the lease is not readily determinable. At the beginning of year six Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to £25,000 a year. At the beginning of year six, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is £210,618 and the right-of-use asset is £184,002.

The scope of the decrease in the right-of-use asset is 50%, as the leased space has decreased from 5,000 square metres to 2,500.

Present value of years 6 – 10 (5 years), £25,000 a year, 3% discount = 114,493

Entry required to adjust the carrying balances to reduce scope (step 1):

DR lease liability	105,309	(210,618 original * 50%)
CR right-of-use asset	92,001	(184,002 original * 50%)
CR gain	13,308	(remainder)

Entry required to adjust lease liability to the required revised balance of £114,493 (step 2):

DR right-of-use asset	9,184	(corresponds to liability adjustment)
CR lease liability	9,184	(£210,618 - £105,309 + £9,184 = £114,493)

Entity B uses an unchanged discount rate of 3% as the decrease in scope is commensurate to the decrease in consideration

BDO Comment

There are two consequences arising from the required accounting for lease modifications that reduce the scope of the lease, but not the lease term itself, that may seem counterintuitive:

- ▶ Firstly, a lease modification that reduces the amount(s) of assets being leased will often result in a gain. This is because at any point in time a lease liability will generally be greater than the leased asset as higher interest charges in the earlier years of the lease result in the lease liability being reduced at a lower rate than the straight line depreciation charge that is typically applied to the right-of-use asset. As the adjustment in step 1 results in the pre-modification carrying amounts of the right-of-use asset and lease liability being reduced by the same proportion, generally more of the lease liability will be derecognised than the right-of-use asset. This may not be the case if the right-of-use asset is not being depreciated on a straight-line basis or the majority of lease payments prior to modification were paid in advance and the reduction in scope was not resulting in a refund of those advance payments

- ▶ Secondly, the gain will be the same irrespective of the amount by which future lease payments are being modified. This is because it is step 2 which ensures the carrying amount of the liability reflects the present value of future lease payments, which is only adjusted against the right-of-use asset. No gain or loss arises from step 2.

The accounting for this type of lease modification reflects that the reduction in scope was effected for nil consideration with total future lease payments being recognised as an expense over the remaining term of the lease. Consequently, any change in the lease cost that relates to future periods will be reflected in depreciation and interest expenses in those future periods.

For modifications that reduce the lease term, whether a gain or loss is recorded will depend on a number of factors, in particular the point at which in the original lease term the reduction takes place. This is because the reduction in the right-of-use asset will typically be calculated on a straight-line basis, while the reduction in the lease liability will be equivalent to the discounted present value of lease payments that are being eliminated.

Example 5.7-3(b) – Lease Modifications that Reduce the Lease Term Only

In contrast to Example 5.7-3(a), this example demonstrates how a lease modification is accounted for when the only change is a reduction in the lease term.

Entity B has a 10-year lease of 5,000 square metres of office space with annual payments of £50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable. At the beginning of year six, Entity B and the lessor agree to reduce the lease term to eight years in total (three years remaining as of the beginning of year six). At the beginning of year six, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is £210,618 and the right-of-use asset is £184,002.

The remeasurement takes place with two steps:

- ▶ Step 1: remeasure based on the decrease in scope (i.e. the decrease in the lease term)
- ▶ Step 2: remeasure based on the change in discount rate.

Step 1: Remeasurement for Decrease in Scope

DR lease liability	76,967 ¹
CR gain	3,366 ²
CR right-of-use asset	73,601 ³

¹ The lease liability is remeasured as the difference between its carrying value immediately prior to the modification (£210,618) and its carrying value based on the revised, shorter lease term, using the original interest rate. The remeasurement related to the change in the discount rate is reflected in Step 2. Three payments of £50,000 occurring in arrears, discounted at 6% (the original discount rate) equals £133,651. £210,618 less £133,651 results in a remeasurement of £76,967.

² The gain is the difference between the adjustment to the lease liability and right-of-use asset (i.e. the balancing entry).

³ The right-of-use asset is remeasured based on the change in scope of the lease. As the remaining lease term has been reduced from five years to three years, the reduction in scope is calculated as the carrying value of the right-of-use asset immediately prior to the modification (£184,002) / 5 * 3.

Step 2: Remeasurement for the Change in Discount Rate

DR right-of-use asset	2,511 ¹
CR lease liability	2,511 ²

¹ The right-of-use asset is adjusted at an amount equal to the lease liability.

² After Step 1, the revised carrying value of the lease liability is its original carrying value (£210,618) less the remeasurement of £76,967, resulting in a revised value of £133,651. The lease liability now needs to be remeasured to reflect the change in the lessee's incremental rate of borrowing, as the adjustment of £76,967 was calculated using an unchanged discount rate. Three payments of £50,000 occurring in arrears, discounted at 5% equals £136,162. The difference between the revised lease liability of £136,162 and the previous value of £133,651 is £2,511.

Alternatively, Entity B may apply the relief in FRS 102 20.72(c) and use an unchanged discount rate in the remeasurement of the lease liability in Step 2. The modification decreases the consideration payable over the remaining term of the lease from £250,000 to £150,000, but does not decrease the scope of the lease by removing the right to use one or more underlying assets. No further adjustment will be required to the right-of-use asset and lease liability.



BDO Comment

In contrast to example 5.7-3(a), in which the scope of the lease was decreased by the number of square feet occupied being reduced, example 5.7-3(b) reduces the scope of the lease by only reducing the remaining lease term. This difference creates a different result in profit or loss, as a reduction in the lease term may result in a gain or a loss, whereas a reduction in scope other than the lease term will often result in a gain.

A reduction in lease term may result in a gain or a loss because of the difference in how the lease liability and right-of-use asset are remeasured in step 1 of the 2-step remeasurement process.

The right-of-use asset is remeasured based on the proportion of the previous carrying value that will remain, based on straight line amortisation. In this example, the revised, remaining lease term is three years instead of the original five, therefore 2/5th of the previous carrying value of the right-of-use asset is eliminated. However, the lease liability is remeasured to eliminate the present value of lease payments that are no longer payable due to the reduction in lease term (discounted at the lessee's original incremental borrowing rate).



Example 5.7-4 – Lease Modification that both increases and decreases the scope of the lease

Entity A enters into a 10-year lease for 2,000 square metres of office space with Entity B. The annual lease payments are £100,000 payable at the end of each year. The rate used to discount the payments due is Entity A's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable.

At the beginning of year six, Entity A and Entity B agree on the following amendments:

- d. Inclusion of additional 1,500 square metres of space in the same building starting from the beginning of year six; and
- e. Reduction of the lease term from 10 years to eight years.

The annual fixed payment for the 3,500 square metres is £150,000 payable at the end of each year (from year six to year eight). Lessee's incremental borrowing rate at the beginning of year six is 7 per cent per annum.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract, as the lease payment per square metre for the original 2,000 square metres of space was £50 and the lease payment per square metre for additional space of 1,500 square metres is £33.33 (£50,000 / 1,500 square metres).



Assessment

As the consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase, Entity A does not account for the increase in scope as a separate lease.

At the commencement of the lease, the lease liability and right-of-use asset are measured at £736,009, being the present value of lease payments of £100,000 for ten years discounted at 6%.

At the beginning of year six, the pre-modification lease liability and right-of-use asset are:

(Amounts in £)

Year	Lease liability				Right-of-use asset		
	Beginning balance	6% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
1	736,009	44,160	(100,000)	680,169	736,009	(73,601)	662,408
2	680,169	40,810	(100,000)	620,979	662,408	(73,601)	588,807
3	620,979	37,259	(100,000)	558,238	588,807	(73,601)	515,206
4	558,238	33,494	(100,000)	491,732	515,206	(73,601)	441,605
5	491,732	29,504	(100,000)	421,236	441,605	(73,601)	368,004
6	421,236				368,004		

A. Decrease in the lease term

► Decrease in right-of-use asset

The proportionate decrease in the right-of-use asset is calculated as below:

	Amount (£)
Pre-modification right-of-use asset, at the beginning of year 6	368,004
Right-of-use asset for the original 2,000 square metres of office space for a reduced term of remaining three years, instead of the original five years	$368,004 * 3/5 = 220,802$
Reduction in right-of-use asset	$368,004 - 220,802 = 147,202$

► Decrease in lease liability

The proportionate decrease in the lease liability is calculated as below:

	Amount (£)
Pre-modification lease liability, at the beginning of year six	421,236
Revised lease liability for the original 2,000 square metres of office space (present value of annual lease payments of £100,000 for three years, discounted at the original discount rate of 6%)	267,301
Reduction in lease liability	$421,236 - 267,301 = 153,935$

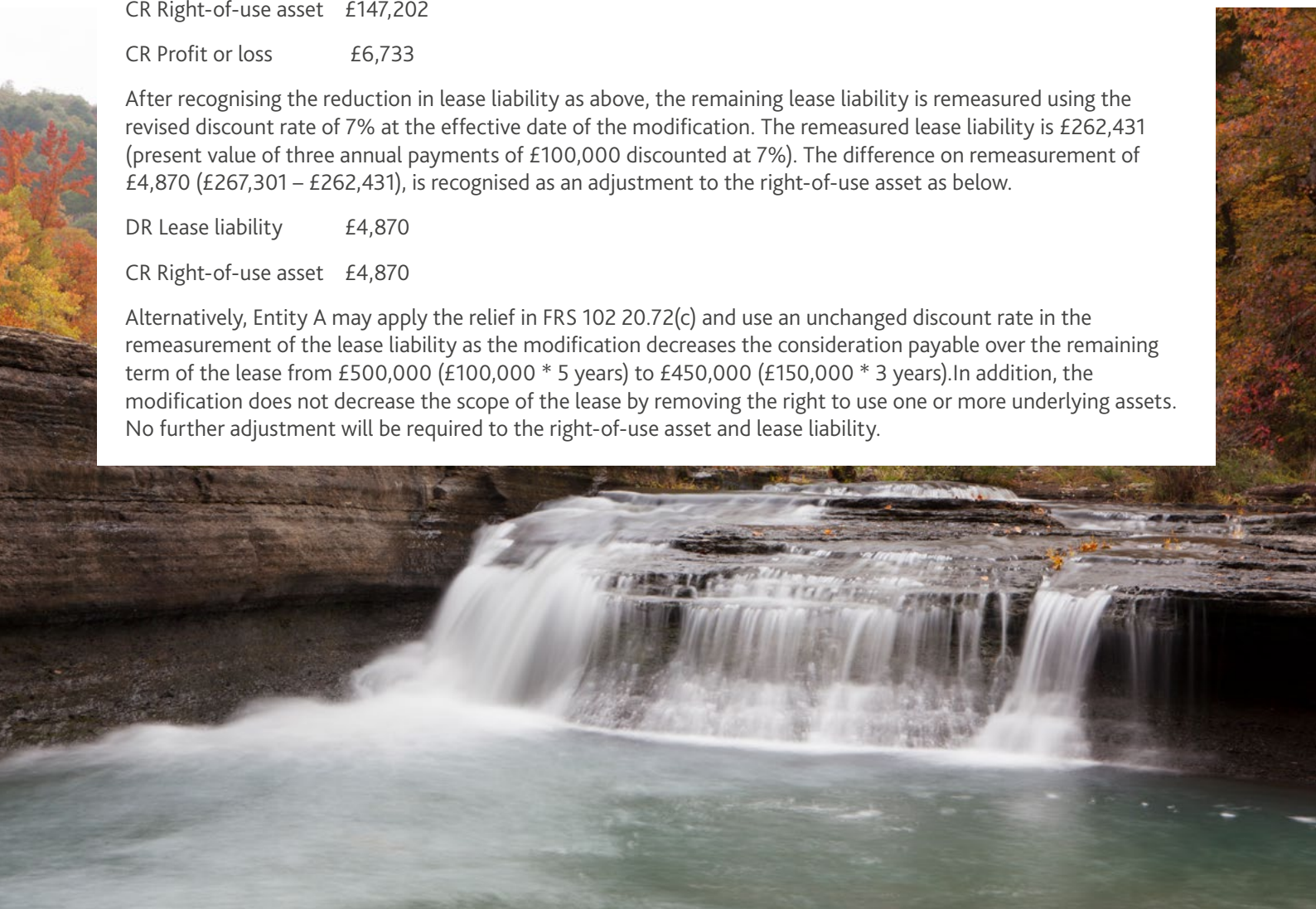
Difference between the reduction in lease liability and the reduction in right-of-use asset ($£153,935 - £147,202 = £6,733$) is recognised as a gain in profit or loss at the effective date of the modification i.e. at the beginning of year six, as below.

DR Lease liability	£153,935
CR Right-of-use asset	£147,202
CR Profit or loss	£6,733

After recognising the reduction in lease liability as above, the remaining lease liability is remeasured using the revised discount rate of 7% at the effective date of the modification. The remeasured lease liability is £262,431 (present value of three annual payments of £100,000 discounted at 7%). The difference on remeasurement of £4,870 ($£267,301 - £262,431$), is recognised as an adjustment to the right-of-use asset as below.

DR Lease liability	£4,870
CR Right-of-use asset	£4,870

Alternatively, Entity A may apply the relief in FRS 102 20.72(c) and use an unchanged discount rate in the remeasurement of the lease liability as the modification decreases the consideration payable over the remaining term of the lease from £500,000 ($£100,000 * 5$ years) to £450,000 ($£150,000 * 3$ years). In addition, the modification does not decrease the scope of the lease by removing the right to use one or more underlying assets. No further adjustment will be required to the right-of-use asset and lease liability.



B. Increase in leased space

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year six), Entity A recognises the increase in the lease liability related to the increase in scope of £131,216 (i.e. present value of three annual lease payments of £50,000, discounted at the revised interest rate of 7 per cent per annum) as an adjustment to the right-of-use asset.

DR Right-of-asset £131,216

CR Lease liability £131,216

After accounting for the increase in scope, the modified right-of-use and the modified lease liability are as follows:

(Amounts in £)

Year	Lease liability				Right-of-use asset		
	Beginning balance	7% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
6	393,647	27,556	(150,000)	271,203	347,148	(115,716)	231,432
7	271,203	18,984	(150,000)	140,187	231,432	(115,716)	115,716
8	140,187	9,813	(150,000)		115,716	(115,716)	

Example 5.7-5 – Purchase of underlying asset by the lessee

On 1 January 20X1, Entity A enters into a property lease with Entity B for a period of 10 years for a fixed monthly rental. The contract does not provide for an extension, termination or purchase option.

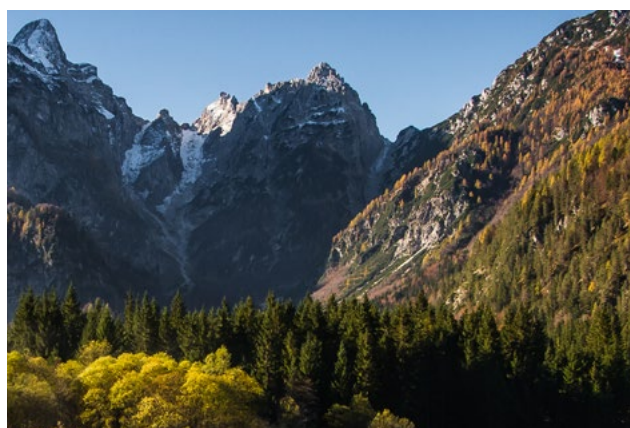
On 31 December 20X5, Entity A agrees to purchase the property from Entity B for £10 million. At that date, the carrying value of the lessee's right-of-use asset and lease liability is £5 million and £5.5 million respectively.

Assessment

There are no specific requirements in Section 20 Leases applicable for this situation.

In our view, an acceptable approach to account for this transaction would be to consider lease termination as an integral part of the purchase of the underlying asset.

The payment of £10 million is treated as an early settlement of the lease liability of £5.5 million and a purchase of the residual interest for an amount of £4.5 million (£10 million – £5.5 million).



Therefore, on purchase, the property asset will be recognised at the purchase price of £10 million less the difference between the lease liability and right-of-use asset of £0.5 million, i.e. £9.5 million.

Following accounting entry is recorded for the transaction:

DR Lease liability £5.5 million
 DR Property asset £9.5 million
 CR Right-of-use asset £5.0 million
 CR Cash £10.0 million

No gain or loss is recognised on the date of purchase.

This treatment is consistent with the outcome if the lessee and the lessor had agreed to modify the lease by inserting a purchase option which is then exercised.

An alternative approach may be to allocate the purchase price on the basis of relative fair value between the settlement of lease liability and purchase of residual interest. In this case, a gain or loss arises to the extent of any difference between the amount allocated to the settlement of the lease liability and its carrying amount. For example, if, on the date of purchase, the fair value of the lease liability exceeds its carrying amount due to a decline in the applicable discount rate, the lessee will allocate an amount exceeding £5.5 million to the settlement of lease liability and the excess is recognised as a loss. This loss is not part of the cost of the property and would be recognised immediately in profit or loss.

Refer to Appendix C for a summary of accounting for subsequent changes to existing leases.

 Appendix C

5.8 Summary of requirements related to discount rate

The following table summarises the requirements in Section 20 Leases with respect to use of original or revised discount rate in case of remeasurement of lease liabilities or lease modifications.

	Discount rate to be used	Section reference
Remeasurement of lease liability		
Change in original assessment of lease term or purchase/termination options	Revised discount rate	▷ Section 5.6
Change in estimate of residual guarantee	Original discount rate (*)	
Change in index or rate affecting payments including market rent reviews	Original discount rate (*)	
Lease modification		
Accounted as a separate lease	Revised discount rate (rate applicable for the leases accounted for separately from the original lease)	▷ Section 5.7
Not accounted as a separate lease	Revised discount rate except in situations below where original discount rate will be used.	
Not accounted as a separate lease and the additional consideration from the lease modification is insignificant to the total consideration of the original lease	Option to use either the original discount rate or a revised discount rate	
The lease modification decreases the scope of the lease by removing the right to use one or more underlying assets, and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope;	Option to use either the original discount rate or a revised discount rate	
The lease modification decreases the consideration payable for the remaining term of the lease, but does not decrease the scope of the lease by removing the right to use one or more underlying assets.	Option to use either the original discount rate or a revised discount rate	

(*) If the change in lease payments results from a change in floating interest rates, the lessee shall use a revised discount rate that reflects changes in the interest rate.

An entity should not reassess the discount rate during the lease term, which is consistent with the approach followed for financial instruments accounted for using the effective interest method. In other Standards in which the discount rate is required to be reassessed, it is typically because the liability to which the discount rate relates is measured on a current value measurement basis. However, when there is a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability and right-of-use asset.

If the change in lease payments results from a change in floating interest rate, the lessee is required to use a revised discount rate for remeasurement of lease liability. This approach is consistent with the requirements of Section 11 Basic Financial Instruments for the measurement of floating-rate financial liabilities subsequently measured at amortised cost.

In case of lease modifications that are accounted for as a separate lease, the discount rate applicable for the new lease (i.e. rate implicit in the separately accounted lease or the incremental borrowing rate for the separately accounted lease) is to be used.

For lease modifications that are not accounted for as a separate lease, the use of a revised discount rate reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate).

6. Presentation

The requirements for the presentation of lease balances and transactions are summarised as follows.

Statement of Financial Position

- ▶ Right-of-use assets: present in its own line item or combine with property, plant and equipment, with separate disclosure*.
- ▶ Lease liabilities: present separately or include with other liabilities and disclose which line item they have been included.

Statement of Profit and Loss

- ▶ Interest expense with other finance costs.
- ▶ Amortisation of right-of-use assets. **

Statement of Cash Flows

- ▶ Cash payments of lease liabilities as financing activities.
- ▶ Cash payments for interest in accordance with Section 7's requirements for interest paid.
- ▶ Short-term, low-value and variable lease payments within operating activities.

* Right-of-use assets that meet the definition of investment property are required to be grouped with investment property.

**Section 20 Leases does not require separate presentation of amortisation expense of right-of-use assets on the face of the income statement, nor does it mandate which line item the amortisation expense should be included (which will in part be driven by whether the entity presents its expenses 'by function' or 'by nature'). However, the expense does need to be disclosed by class of underlying assets in the notes.

FRS 102 20.74(a)(i) states that if an entity wishes to group right-of-use assets with other assets, they must be grouped 'within the same line item as that within which the corresponding underlying assets would be presented if they were owned'. FRS 102 20.74(a)(ii) requires the entity to disclose which line items in the statement of financial position include those right-of-use assets. As an exception to this requirement, if a right-of-use asset meets the definition of investment property under Section 16 Investment Property, then the asset must be presented within the same line item as other investment property (i.e. not combined with other right-of-use assets that do not meet the definition of investment property).

For example, if a lessee had a right-of-use asset relating to a lease of heavy equipment, that right-of-use asset would be grouped with property, plant and equipment in the statement of financial position, unless the lessee elects to present right-of-use assets as a separate line item. The lessee would be required to disclose that the right-of-use asset is included in the line item of property, plant and equipment in the statement of financial position.

FRS 102 entities apply either the statutory or adapted balance sheet format. Under the statutory format, entities are required to present right-of-use assets as either fixed or current assets. A right-of-use asset should be classified in its entirety within a single balance sheet category. In practice, this will typically result in the ROU asset being classified consistently with the nature of the underlying leased asset. Assets that are subject to depreciation or amortisation will generally meet the definition of fixed assets. Accordingly, where the underlying leased asset is intended for continuing use in the entity's operations, the related ROU asset will normally be classified as a fixed asset.

Under the adapted format, the balance sheet uses the distinction between non-current and current assets. Although the definitions of fixed assets and non-current assets differ, in practice a ROU asset presented under the adapted format will usually be classified in the same category as the underlying leased asset, and therefore typically within non-current assets.

7. Disclosure

Section 20 Leases has disclosure requirements for lessees in both qualitative and quantitative form. Quantitative disclosure requirements by primary statement include the following (some of which may be disclosed in the notes and not in the statement of financial position or the statement of comprehensive income):

Quantitative Disclosure Requirements

Statement of Financial Position

- ▶ Additions to right-of-use assets.
- ▶ Disposals
- ▶ Acquisitions through business combination
- ▶ Revaluation
- ▶ Impairment losses and reversal of impairment losses
- ▶ Depreciation
- ▶ Other changes
- ▶ Carrying value of right-of-use assets at the end of the reporting period by class.

Statement of Profit and Loss

- ▶ Depreciation for assets by class.
- ▶ Interest expense on lease liabilities.
- ▶ Short-term leases expensed (accounted for applying FRS 102 20.6).
- ▶ Low-value leases expensed (accounted for applying FRS 102 20.6).
- ▶ Variable lease payments expensed.
- ▶ Income from subleasing.
- ▶ Gains or losses arising from sale and leaseback transactions.

Statement of Cash Flows

- ▶ Total cash outflow for leases.

Other disclosure requirements include:

- ▶ For right-of-use assets that meet the definition of investment property, the disclosure requirements of Section 16 Investment Property, with a few exclusions.
- ▶ For right-of-use assets where the revaluation model has been applied, the disclosure requirements of Section 17 Property, Plant and Equipment.
- ▶ Lessee to disclose separately the amount of its lease commitments for short-term leases and for leases of low value assets at the end of the reporting period, for each of the following periods:
 - a. not later than one year;
 - b. later than one year and not later than five years; and
 - c. later than five years

Qualitative Disclosure Requirements

- ▶ A general description of the lessee's significant leasing activities;
- ▶ Potential cash outflows the entity is exposed to that are not included in the lease liability, including:
 - Variable lease payments;
 - Extension options and termination options;
 - Residual value guarantees; and
 - Leases not yet commenced to which the lessee is committed.
- ▶ Restrictions or covenants imposed by leases;
- ▶ the types of discount rate (interest rate implicit in the lease, lessee's incremental borrowing rate or lessee's obtainable borrowing rate) used in calculating lease liabilities and the proportion of the total lease liability calculated using each of those types of discount rate; and
- ▶ Information about sale and leaseback transactions.
- ▶ Disclose when lessee has used unchanged discount rates for lease modifications and carrying amount at the end of the reporting period for such leases

Refer BDO's Illustrative FRS 102 Financial Statements [here](#) for illustrative disclosures.

8. Lessor accounting

The accounting requirements in Section 20 Leases for lessors are unchanged in most respects from old FRS 102. Leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases. All other leases are operating leases.

BDO comment

For leases that are classified as operating leases by the lessor, the lessee will also recognise an asset for the same underlying asset in its statement of financial position: the lessor the actual asset and the lessee a right-of-use of that asset.

The areas that may affect lessors are those where revised Section 20 Leases expands guidance or provides guidance on issues not previously addressed in old Section 20 Leases, such as:

- ▶ the new definition of a lease (see chapter 3);
 - ▷ Chapter 3
- ▶ revised sale-and-leaseback guidance (see section 9);
 - ▷ Section 9
- ▶ sub-lease guidance (see section 8.3);
 - ▷ Section 8.3
- ▶ guidance on lease modifications (see section 8.6); and
 - ▷ Section 8.6
- ▶ enhanced disclosure requirements (see section 8.9).
 - ▷ Section 8.9



8.1 Distinction between a Lease and a Sale or Purchase

Section 20 Leases does not include specific requirements to distinguish a lease from a sale or purchase of an asset.

Accounting for a transaction depends on the substance of that transaction and not its legal form. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, those rights meet the definition of property, plant and equipment in Section 17 Property, Plant and Equipment and would be accounted for applying that Standard, regardless of whether legal title transfers. If the contract grants rights that do not represent the in-substance purchase of an item of property, plant and equipment but that meet the definition of a lease, the contract would be accounted for applying Section 20 Leases.

The primary basis for distinction between a lease and a sale or a purchase is the assessment of whether the contract conveys the right to use an underlying asset or whether it transfers control of the underlying asset. Section 20 Leases applies to contracts that convey the right to use an underlying asset for a period of time. Transactions that transfer control of the underlying asset to an entity are sales or purchases within the scope of other Standards such as Section 23 Revenue from Contracts with Customers or Section 17 Property, Plant and Equipment.

The scoping requirements of Section 23 Revenue from Contracts with Customers provide as below:

FRS 102 23.1 (emphasis added)

An entity shall apply this Standard to all contracts with customers, except the following:

- a. *Lease contracts within the scope of Section 20 Leases...*

Thus, as Section 23 Revenue from Contracts with Customers scopes out lease contracts within the scope of Section 20 Leases, an entity first determines whether the arrangement meets the definition of a lease in accordance with the requirements of Section 20 Leases. If the entity determines that the contract meets the definition of a lease, the entity needs to determine whether the lease contains any non-lease components. Lessors are required to apply the principles within Section 23 Revenue from Contracts with Customers for allocating consideration to components of a contract (refer section 8.2).

8.2 Separation of Lease and non-Lease Components

Unlike lessees, lessors do not have an option to account for a contract that contains both a lease and non-lease component as a single lease. Lessors must use the principles within Section 23 Revenue from Contracts with Customers for allocating consideration to components of a contract.

This may result in significantly different outcomes than if the entire contract were within the scope of Section 23 Revenue from Contracts with Customers. For example, Section 23 Revenue from Contracts with Customers contains specific guidance on variable consideration, where variable consideration should be included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved ('the variable consideration constraint').

Variable payments under a lease classified as an operating lease for a lessor would typically be included in income as the contingency is resolved.

Therefore, determining whether a contract is in the scope of Section 23 *Revenue from Contracts with Customers*, Section 20 *Leases* or partially within both standards, may significantly alter the pattern of revenue recognition. It should be noted that separation is required even if it only affects presentation and disclosure. Disaggregation of different revenue streams is required by Section 23 *Revenue from Contracts with Customers* and Section 20 *Leases*.

8.3 Sub-Leases

A lessee may become an intermediate lessor if it sub-leases an asset it in turn leases from another lessor (the 'head lessor'). An intermediate lessor assesses whether the sub-lease is a finance or operating lease in the context of the right-of-use asset being leased, not the actual underlying asset.



Example 8.3-1 – Sub-Lease Assessment

An intermediate lessor enters into a five year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).

At the beginning of year three, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sub-lessee.



Assessment

From the intermediate lessor's perspective, at the time the sub-lease is entered into, the right-of-use asset has a remaining economic life of three years, and it is being sub-leased for the entirety of that period. As the sub-lease is for all of the remaining useful economic life of the right-of-use asset the sub-lease is classified as a finance lease, even though three years is unlikely to be the full remaining useful economic life of the underlying property.

BDO comment

Sub-leases may result in right-of-use assets being classified as finance leases from the perspective of the intermediate lessor while being classified by the head lessor as operating leases. In the example above, the underlying asset is real estate, which would typically be classified as an operating lease by the head lessor since most real estate leases do not transfer substantially all of the risks and rewards of ownership.

However, because the asset held by the intermediate lessor is a right-of-use asset with a much shorter useful economic life, the classification of the sub-lease by the intermediate lessor may differ from that of the head lessor.

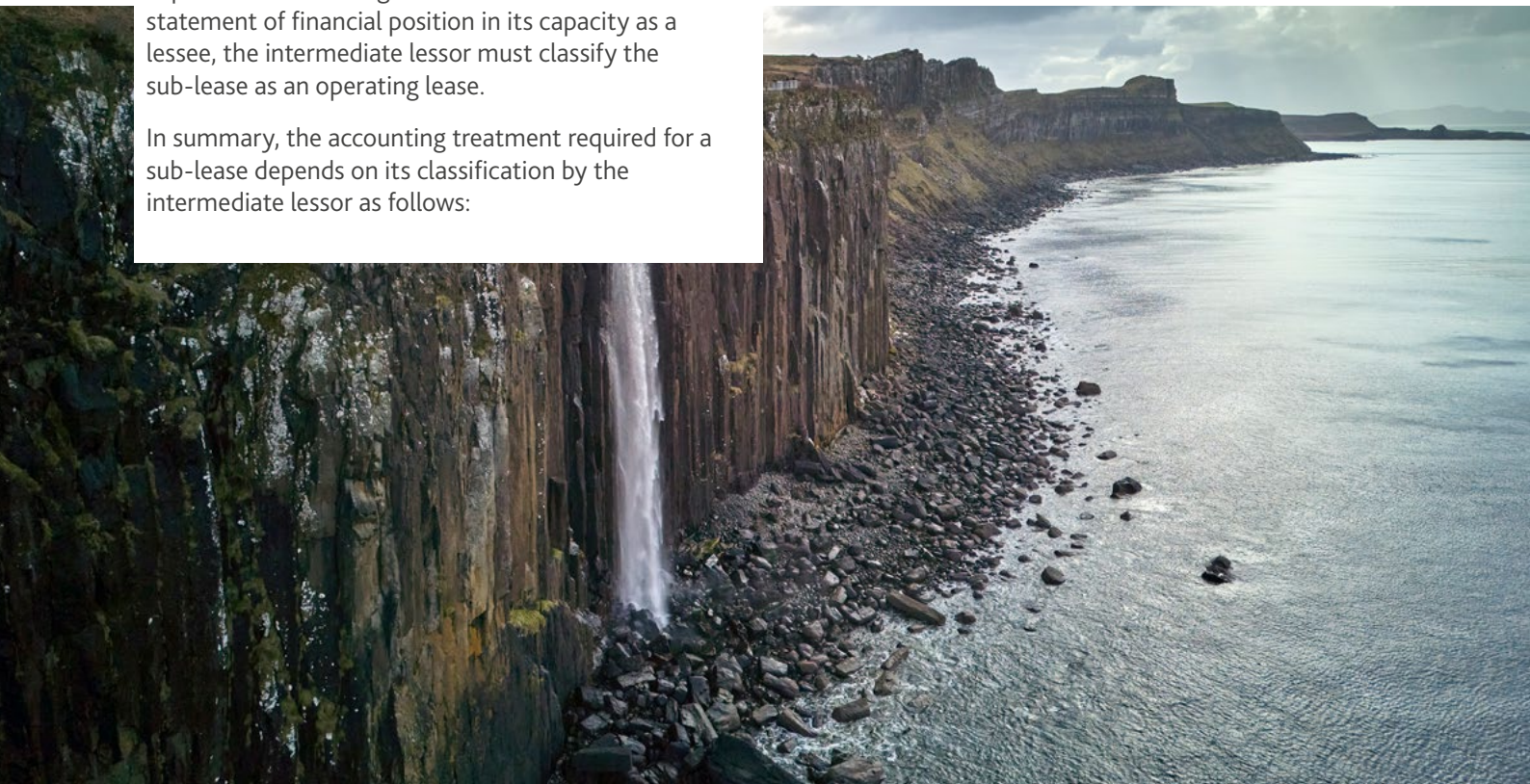
Assessing whether a sub-lease is a finance or operating lease may be more difficult in situations where the whole asset is not sub-leased (e.g. a portion of real estate for a portion of the head lease term).

When a head lease is short-term and the intermediate lessor takes advantage of the related practical expedient not to recognise short-term leases in its statement of financial position in its capacity as a lessee, the intermediate lessor must classify the sub-lease as an operating lease.

In summary, the accounting treatment required for a sub-lease depends on its classification by the intermediate lessor as follows:

Finance leases	Operating leases
<ul style="list-style-type: none"> ▶ Derecognise the right-of-use asset (1) and recognise instead a lease receivable equal to the net investment in the sub-lease (2) * ▶ Recognise the difference between (1) and (2) as a gain or loss in the income statement ▶ Retain the previously recognised lease liability in capacity as lessee and recognise interest expense thereon; and ▶ Recognise interest income on the lease receivable in capacity as finance lessor. 	<ul style="list-style-type: none"> ▶ Retain the right-of-use asset in capacity as lessee and continue to recognise depreciation thereon ▶ Retain the lease liability in capacity as lessee and continue to recognise interest expense thereon ▶ Recognise lease income from the sub-lease in capacity as operating lessor

* A lessor uses the interest rate implicit in the lease to measure the net investment in the sublease. If the interest rate implicit in the sublease cannot be readily determined, the intermediate lessor may use the discount rate used for the head lease, adjusted for any initial direct costs associated with the sublease.

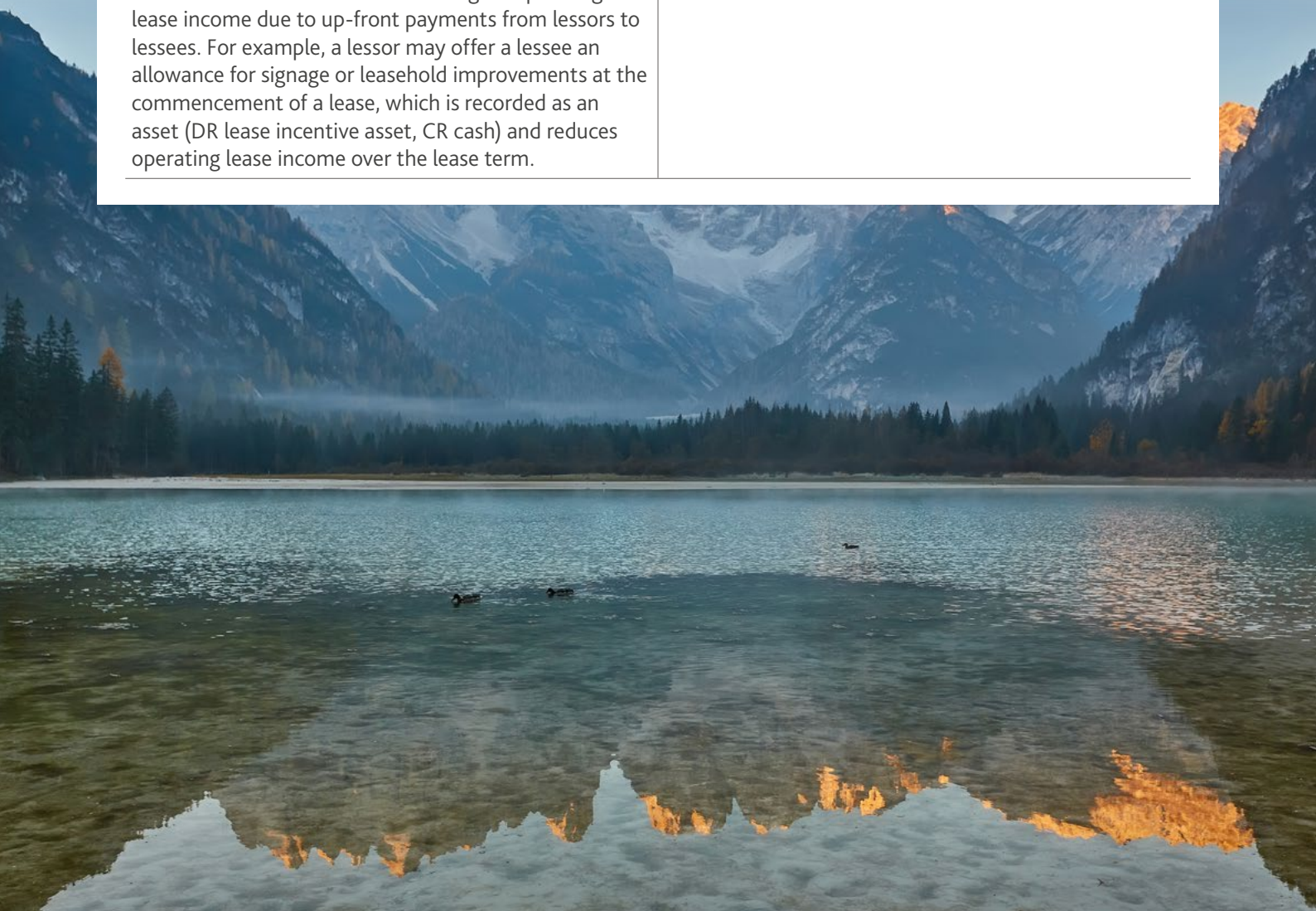


8.4 Impairment of lease receivables

As required by FRS 102 11.7(c), lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of Section 11 Basic Financial Instruments.

Specific to operating type leases, amounts recognised in the statement of financial position relating to leases may include:

Balance arising from operating lease requirements	Impairment requirements
<p>Amounts currently receivable (e.g. £100 of rent due for a period in accordance with the terms of the lease contract).</p>	<p>Within the scope of Section 11 <i>Basic Financial Instruments</i> impairment requirement, as these are lease receivables. The lessor has an unconditional right to collect these contractual cash flows.</p>
<p>Assets that arise from the 'smoothing' of operating lease income due to variability in the periodic cash payments. For example, if the timing of cash payments in an operating lease is deferred (e.g. an initial 6 months 'rent-free period'), then an asset will be recorded during that period, despite cash not being contractually due until a later period (e.g. DR asset, CR operating lease income during the rent-free period).</p> <p>For example, if a lessor offers a 6 month rent-free period, and as at the reporting date, 2 months have elapsed, the lessor will have recognised an asset due to the recognition of operating lease income over these 2 months, however, the lessor has no unconditional right to collect cash from the lessee at that reporting date.</p>	<p>The term 'operating lease receivables' is not defined in FRS 102. Section 20 <i>Leases</i> refers to prepaid or accrued lease payments, however, these terms are not defined in Section 20 <i>Leases</i>.</p> <p>The derecognition and impairment requirements in Section 11 <i>Basic Financial Instruments</i> and 12 <i>Other Financial Instruments</i> Issues are applicable to the operating lease receivables. However, it is not clear whether impairment requirements in Section 20 <i>Leases</i> apply to accrued lease payments, as lessors do not have an unconditional right to collect cash flows relating to these assets at the reporting date (subject to any credit terms), which is a fundamental characteristic of a financial asset.</p>
<p>Assets that arise from the 'smoothing' of operating lease income due to up-front payments from lessors to lessees. For example, a lessor may offer a lessee an allowance for signage or leasehold improvements at the commencement of a lease, which is recorded as an asset (DR lease incentive asset, CR cash) and reduces operating lease income over the lease term.</p>	



8.5 Common issues arising when accounting for operating leases

8.5.1 Accounting for operating leases in case of restricted access to underlying assets

► Basis of recognition of operating lease income:

Sometimes, lessors restrict access to the underlying assets. For example, during the COVID-19 pandemic, lessors were required to restrict access to the underlying assets (e.g. real estate, offices, retail locations etc.) due to restriction imposed by governments. In such circumstances, a question arises whether the lessors can change the basis over which they recognise operating lease income.

FRS 102 20.106 states that:

*A lessor shall recognise lease payments from operating leases as **income** on a straight-line basis, unless either:*

- a. another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished; or
- b. the lease payments are structured to increase in line with expected general inflation (based on published indices or statistics) to compensate for the lessor's expected inflationary cost increases. If the lease payments vary according to factors other than general inflation, then this condition is not met.

Lessors will have developed an accounting policy for leases prior to the restrictions being imposed, for example due to COVID-19. In practice, most operating lease income is recognised on a straight-line basis, as this generally represents the pattern in which benefit from the use of the underlying asset is diminished. It is rare that another basis of recognition is more representative.

For a lessor to change its accounting policy, it would have to satisfy the requirements of FRS 102 10.8(b), which requires that a change in accounting policy that is not required by an FRS must 'result in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.'

Rarely would a change in the pattern of recognition of operating lease income due to restrictions such as those during COVID-19 satisfy this requirement. For example, suspending the recognition of operating lease income because the underlying asset's availability to the lessee has been diminished due to government imposed lockdown would generally not better represent the pattern in which the benefit from the use of the underlying asset is diminished. This is because the lessee still has the right to direct use of the asset based on the lease contract during a period of lockdown or

restriction; those rights are simply modified by changes in local law or regulation.

► Basis of depreciation of the underlying asset

Another issue that arises in case of restriction of access to underlying assets is whether the lessor can suspend or modify the basis for depreciating the underlying asset (e.g. a building when tenants are not permitted to access it due to government lockdown).

Generally, FRS 102 17.18 requires the depreciable amount of an asset to be allocated on a systematic basis over its useful life. FRS 102 17.20 requires that (emphasis added):

... Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognised.

Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Therefore, the use of an underlying asset, such as a building, being diminished due to restriction of access (e.g. during the COVID-19 pandemic) does not justify or result in the cessation of depreciation.

8.6 Lease Modifications

The accounting for lease modifications depends on whether the lease is classified as a finance lease or an operating lease from the lessor's perspective immediately prior to the modification.

8.6.1 Finance Leases

Modifications - Separate Leases

A finance lessor needs to consider the same criteria as the lessee when the contract is modified. Therefore, a modification to a lease classified as a finance lease is accounted for as a separate lease if both:

- ▶ the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- ▶ the consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract

If both criteria are met, a lessor would follow the lessor guidance on recognition and measurement of that separate lease.

Modifications – Not Separate Leases

If a modification to a finance lease does not meet both of the above criteria, the lessor follows the following guidance:

Applying the modified contract from inception, the lease would have been classified as an operating lease

All other lease modifications

- ▶ Account for the lease modification as a new lease from the effective date of the modification; and
- ▶ Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

- ▶ Apply the requirements of Section 11 or 12 depending on the accounting policy choice made under FRS 102 11.2 or 12.2.

The remeasurements above occur on the inception date of the lease modification on a prospective basis.



8.6.2 Operating Leases

Any modification to a lease contract that was classified as an operating lease results in the modified contract being accounted for as a new lease from the date of modification. Any debtor or deferred rental income that is on balance sheet in respect of the original lease at the modification date is considered to be part of the lease payments for the new lease.

Therefore, if the modified lease contract is also classified as an operating lease, no adjustment is made to the carrying value of the leased asset, although the period over which it is depreciated may change. The period over which any previously recognised debtor (relating to accrued rents received) is settled or deferred income (relating to rents received in advance) released to the income statement may also change.

If the modified lease contract is classified as a finance lease, then the asset being leased is derecognised and a receivable recognised instead equal to the net investment in the lease.

Change in consideration which is not a lease modification

In some cases, there may be a change in consideration which is not a lease modification. In such cases, the lessor would account for these payments as if they were part of the original terms and conditions of the lease. Section 20 Leases does not contain specific requirements for how a lessor recognises the effect of variable lease payments, however, FRS 102 20.116(b) requires disclosure of 'income relating to variable lease payments that do not depend on an index or rate', implying that such payments are included in profit or loss, similar to the requirement for lessees.

Therefore, lessors will generally reflect variable lease payments that do not depend on an index or rate in profit or loss in the period in which the event or condition that triggers those payments occurs.

For example, lessee and lessor enter into a contract for the lease of retail space for a lease term of five years, with lease payments of £100 per month. The original lease contract contains a clause that if the shopping centre is shut down due to government-imposed intervention, then the lessee will receive a 75% discount on lease payments for as long as the shopping centre remains closed. Subsequently, government restricts access to the shopping centre on account of the public health issue or other events. As a result, the lessee receives a 75% discount on lease payments during the period of closure of the shopping centre.

This is not a lease modification because the change in consideration results from the original terms and condition of the lease. The lessor would reflect the reduction in operating lease income in each of the periods where the reduction is triggered by the shopping centre remaining closed. Therefore, if monthly operating income would have otherwise been £100 per month, the lessor would record £25 (£100 – 75% reduction) of operating lease income.



Example 8.6.2-1 – Change in operating lease payments relating to future periods

Lessor entered into a lease with lessee on 1 January 2019 for a lease term of five years. Monthly operating lease payments are £100 per month (£100 * 60 months = £6,000 total consideration).

On 1 May 2020, lessor agrees to reduce May – December 2020 rent to £50 due to the effects of the pandemic. Therefore, remaining revised consideration is £4,000 (£50 * 8 months in 2020 + £100 * 36 months from 2021 – 2023).

Assessment

The rent concession in this case meets the definition of a lease modification in FRS 102 Glossary as it is 'a change in ... the consideration for a lease ... that was not part of the original terms and conditions of the lease'. Therefore, in accordance with FRS 102 20.112, the lessor accounts for the modified lease as a new lease from the date the rent concession is granted.

FRS 102 20.112 requires a lessor to consider any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Therefore, as at the effective date of the modification, the total revised consideration for the remaining lease, plus prepaid or accrued lease payments, is reallocated to and recognised over the remaining lease term.

From 1 May 2020 onward, lessor recognises £4,000 / 44 months = £90.90 per month as operating lease income.

For example, to accrue May 2020 operating lease income, lessor records (assuming Lessee pays in advance):

DR cash	50 (equal to revised consideration for May – December 2020)
DR lease receivable	40.90 (difference between operating lease income and cash)
CR operating lease income	90.90 (operating lease income, as calculated above)

Accounting for unamortised lease incentives as at the time of the lease modification and on a go forward basis

Lessors may provide lease incentives to lessees, often at the commencement of a new lease. For example, allowances for leasehold improvements, reimbursements of certain costs, etc. Included in the definition of 'lease payments' is that they include fixed payments less any 'lease incentives', therefore, when a lessor recognises operating lease income in accordance with FRS 102 20.106, the effect of these lease incentives are typically spread over the lease term.

For example, if a lessor provides a lessee with £500 in cash to make leasehold improvements at the commencement of a lease, the lessor will account for the payment as an asset (e.g. DR asset, CR cash) and amortise that asset as an adjustment of operating lease income over the lease term. c requires lease modifications to operating leases to be accounted for as 'new leases' as at the effective date of the modification, the question arises as to how these assets recorded as at the commencement of the original lease should be accounted for in the 'new lease'.

In our view, these assets should be included in the calculation of operating lease income in the 'new lease'. That is, the assets should continue to amortise over the lease term of the new lease. This is because FRS 102 20.112 states (emphasis added):

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

The asset recorded relating to lease incentives may be considered as a 'prepaid lease payment', as a lease incentive is an adjustment in the total consideration for the lease.

Accounting for a change in the timing of lease payments when the nominal cash flows are unchanged

Generally, when a lessor determines how to recognise operating lease income over the lease term, the resulting calculation does not reflect the time value of money.

If a lessor grants a rent concession that affects the timing of payments, but not the nominal cash flows, and the concession is a lease modification, then the change in timing will not result in a change in operating lease income. This is because, as noted above, the allocation of total consideration to the discrete periods in the lease term does not generally consider the time value of money.



Example 8.6.2-2 – Change in timing of lease payments when the nominal cash flows are unchanged

Lessor enters into a lease with lessee on 1 January 20X1 for a lease term of three years. The operating lease payments for the first year are £1,100 per month and they increase by £100 every year.

In April 20X2, due to financial difficulties, the lessee requests for a deferral of lease payments. The lessor provides for a deferral of April-June 20X2 lease payments. These will be amortised 1/12th per month from July 20X2-June 20X3.

Assessment

As required by FRS 102 20.106, the lessor recognises operating lease income on a straight-line basis over the lease term. The monthly operating lease income to be recognised is calculated as below:

$$\begin{aligned} & ((£1,100 * 12 \text{ months in } 20X1) + (£1,200 * 12 \text{ months in } 20X2) + (£1,300 * 12 \text{ months in } 20X3)) / 36 \\ & = £1,200 \end{aligned}$$

The operating lease income recognised from January 20X1 to March 20X2 is £18,000 (£1,200 * 15 months).

The total operating lease payment for this period is as below:

$$\begin{aligned} & ((£1,100 * 12 \text{ months in } 20X1) + (£1,200 * 3 \text{ months } \\ & \text{January-March } 20X2)) \\ & = £16,800 \end{aligned}$$

Therefore, the accrued lease payment recognised as on 31 March 20X2 is £1,200 (i.e. £18,000 less £16,800).

Deferring April – June 20X2 rent and amortising it 1/12th per month from July 20X2 – June 20X3 would not result in a change in operating lease income recognised on a monthly basis.

The monthly operating lease income from the period April 20X2-December 20X3 is calculated as below:

$$\begin{aligned} & ((£0 * 3 \text{ months April-June } 20X2) + (£1,300 * 6 \text{ months } \\ & \text{July-December } 20X2) + \\ & (£1,400 * 6 \text{ months January- June } 20X3) + (£1,300 * 6 \\ & \text{months July-December } 20X3) + \\ & (\text{Accrued lease payments of } £1,200)) / 21 \\ & = £1,200 \end{aligned}$$

Thus, the monthly operating lease income remains the same after rent deferral.

8.7 Charity leases as a social investment

A charity granting a lease on nominal or peppercorn terms is not considered to have made a lease of commercial substance. Charities may do so to further their charitable purposes where the lessee is a beneficiary, or it may be a route to assisting the ultimate beneficiaries if the charity. The charity retains title to the asset and because it is leasing it as the means of furthering its charitable purposes, treats the asset in the same way as other assets it owns with an appropriate charge for depreciation and an annual impairment review. FRS 102 SORP 2026 requires income receivable under such arrangements to be treated as annual rental income.

A charity entering into a finance lease at below market rent to a lessee is making a social investment and is, in substance, offering a concessionary loan to the lessee. Under FRS 102 SORP 2026 the measurement of the net investment in the lease and recognition of the finance income is the same as a finance lease but FRS 102 SORP 2026 requires the charity to class these as a separate component of its concessionary loans.

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 from that any other operating lease. While the lease payments may be significantly below market rents, this is unlikely to be an impairment indicator because the asset is performing its intended purpose of providing social or charitable benefit.

8.8 Manufacturer/ dealer lessors

FRS 102 distinguishes manufacturer/dealer lessors from other lessors due to the nature of their business model and the way in which leased assets are sourced.

At the commencement date, FRS 102 20.97 requires a manufacturer or dealer lessor to recognise the following for each of its finance leases:

- a. revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;
- b. the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value; and
- c. selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which Section 23 Revenue from Contracts with Customers applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in Section 23 Revenue from Contracts with Customers.

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts.

If artificially low rates of interest are quoted, a manufacturer or dealer lessor restricts selling profit to that which would apply if a market rate of interest were charged.

Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

In the case of an operating lease, the manufacturer or dealer has retained the asset with a view to using it to generate rental income. Consequently, no selling profit should be recognised and the asset should be included in the statement of financial position as a fixed asset, initially at its purchase price or production cost.



8.9 Disclosure Requirements

Disclosure requirements for lessors are summarised as follows:

Qualitative Disclosure Requirements

Finance leases	Operating leases
<ul style="list-style-type: none"> ▶ Selling profit or loss; ▶ Finance income on the net investment; ▶ Income from variable lease payments; ▶ Qualitative and quantitative explanation of significant changes in the net investment; ▶ Maturity analysis of lease payments receivable, on an undiscounted basis for a minimum of each of the first five years and a total of the amounts for the remaining years, along with reconciliation of undiscounted lease payments to the net investment in the lease; ▶ Unearned finance income relating to lease payments receivable and any undiscounted residual guarantee; and ▶ Accumulated allowance for uncollectible lease payments receivable 	<ul style="list-style-type: none"> ▶ Lease income, separately disclosing variable lease payments that do not depend on an index or a rate; ▶ Disclosure requirements of Section 17 for leased assets, separating leased assets from non-leased assets; ▶ Other applicable disclosure requirements based on the nature of the underlying asset (eg. Section 16, 18, 27 and 34); and ▶ Maturity analysis of lease payments, on an undiscounted basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

Similar to the lessee disclosure requirements, Section 20 Leases requires a lessor to general description of its significant leasing arrangements, including, if necessary to enable users to understand those arrangements, information about variable lease payments, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

If necessary to enable users to understand its significant leasing arrangements, a lessor shall disclose additional qualitative and quantitative information.

If a charity grants a lease as a social investment or arrangements with nil or nominal consideration, FRS 102 SORP 2026 requires the charity to provide a general description of the lease term, the remaining lease term if not a perpetual lease, and the charitable purpose effected by granting such leases.



9. Sale-and-leaseback transactions

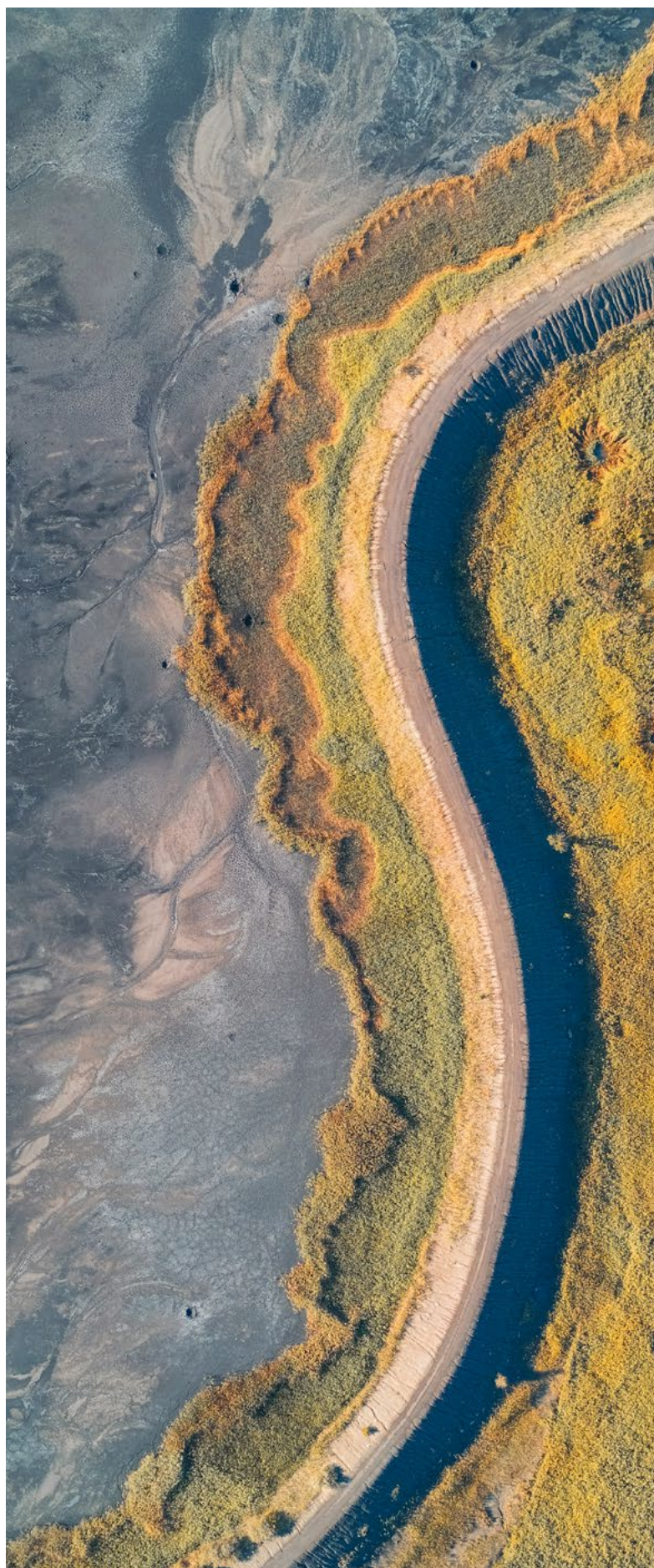
In a sale-and-leaseback transaction ('SALT'), an entity (seller-lessee) sells an asset to another entity (buyer-lessor) who then leases it back to the seller-lessee. The seller-lessee can thereby immediately receive liquid funds from the buyer-lessor and still keep its right to use the asset sold through the leaseback side of the contract. Often the fair value of the asset is greater than its book value, and so entering into a SALT can result in an accounting profit being recognised.

In order to determine the appropriate accounting treatment under FRS 102, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of Section 23 *Revenue from Contracts with Customers*. Please refer to our separate In Practice document on revenue under FRS 102.

BDO comment

If the underlying lease in a SALT would be classified as a finance lease by the buyer-lessor, it is unlikely that the transaction would satisfy the conditions in Section 23 *Revenue from Contracts with Customers* (i.e. it is likely that control would not have passed). However, the indicators used to assess whether a lease is operating or finance focuses on risks and rewards rather than control (which is the criterion in Section 23 *Revenue from Contracts with Customers*).

Despite this distinction, it would be unusual for a SALT to satisfy the control criteria in Section 23 *Revenue from Contracts with Customers* if the resulting lease transferred substantially all of the risks and rewards to the seller-lessee. However, in very limited circumstances a transaction may satisfy the control criteria in Section 23 *Revenue from Contracts with Customers*, but nonetheless be classified as a finance lease (for example, in a situation where the lease is classified as a finance lease due to the underlying asset being of a highly specialised nature (FRS 102 20.88(e))).



	Lessee (seller)	Lessor (buyer)
Transfer to buyer- lessor qualifies as a sale	<ul style="list-style-type: none"> ▶ Derecognise underlying asset and apply lessee accounting requirements. ▶ Choice of: <ol style="list-style-type: none"> 1. Measure right-of-use asset as the retained portion of the previous carrying value and recognise a gain or loss on the rights transferred to the lessor, OR 2. Measure right-of-use asset in the same way as for any other right-of-use asset. Any excess of the sales proceeds over the previous carrying amount of the asset is deferred and amortised over the lease term. Any shortfall is recognised immediately in profit or loss. 	<ul style="list-style-type: none"> ▶ Apply applicable sections of FRS 102 to the asset purchased and lessor accounting requirements to the lease contract.
Transfer to buyer- lessor does not qualify as a sale	<ul style="list-style-type: none"> ▶ Continue recognition of asset. ▶ Amounts received are recognised as a financial liability. 	<ul style="list-style-type: none"> ▶ Asset purchased is not recognised. ▶ Amounts paid are recognised as a financial asset.

If the sale side of the transaction does qualify as a sale, it is necessary to consider whether the sales price as stated in the contract is equal to the asset's fair value. In an arm's length transaction it is highly likely that the totality of the sale and leaseback transaction is on-market. However, this does not prevent the consideration received on the sale side of the contract being off market, with compensating off-market lease payments on the leaseback side of the transaction. Therefore, FRS 102 requires the profit or loss on the sale side of the transaction from the lessee's perspective (and initial measurement of the asset purchased from the lessor's perspective) to be determined by reference to the fair value of the asset, not the stated contractual sale price. Consequently, lessees need to determine the fair value of the asset in order to ensure they recognise the correct profit or loss on sale (as do lessors for the purposes of accounting for the cost of the asset) rather than assuming the asset's fair value equals the stated contractual sales price.

If it is determined that the fair value of the asset is less than or greater than the contractual sales price, then the difference is accounted for by the lessee as additional borrowing or a prepayment, respectively. Similarly, the lessor accounts for the difference as rents receivable or deferred rental income, respectively, (if

the leaseback is classified as an operating lease) or an adjustment to the finance lease receivable (if the leaseback is classified as a finance lease).

In some cases, it may be easier to compare the contractual leaseback rentals to market rentals rather than the contractual sales price to the fair value of the leased asset, in which case the standard also permits this approach when determining whether both sides of the SALT transaction are at open market rates.

As a further complication in the calculation of the lessee's profit or loss on disposal, it needs to be remembered that a seller-lessee does not transfer control of the whole asset to the buyer-lessor, because it continues to control the same asset during the leaseback period. It is only losing control of the asset subsequent to the leaseback period. Therefore, the seller-lessee's profit or loss on disposal will not simply be equal to the fair value of the asset less its carrying amount. Instead, it is the amount of consideration attributable to the portion of the asset for which control has passed to the buyer-lessor (i.e. monies received which do not have to be paid back to the lessor over the leaseback period) less the portion of the asset's carrying amount attributable to the period after the end of the leaseback and for which control has passed to the buyer-lessor.



Example 9-1 – Sale-and-leaseback transaction where transfer is a sale (lessee)

A seller-lessee enters into a sale and leaseback transaction whereby it sells a property to a buyer-lessor for £2,000,000. Simultaneously, the seller-lessee leases the property back from the buyer-lessor for a period of 18 years with annual lease payments at the end of each year of £120,000. The sale meets the criteria of Section 23 Revenue from Contracts with Customers to be accounted for as a sale. There are no initial direct costs in the transaction. Before the transaction occurs, the property has a carrying value of £1,000,000.

The fair value of the property at the time of sale is £1,800,000. Since the consideration does not equal fair value, adjustments must be made to determine any gain or loss arising by reference to the asset's fair value. The excess consideration of £200,000 (£2,000,000 – £1,800,000) is therefore accounted for as additional financing provided by the buyer-lessor to the seller-lessee, not consideration on the sale side of the transaction.

The discount rate is 4.5% per annum determined by reference to the seller-lessee's incremental borrowing rate as the rate inherent in the lease is not readily determinable. The present value of the annual leaseback payments (18 payments of £120,000, 4.5% discount per annum) is £1,459,200.

Assessment

The entry to record this transaction is as follows (see corresponding notes reconciling each component of the entry):

DR Cash	2,000,000 ¹
DR Right-of-use asset	699,555 ²
CR PPE (the property sold)	1,000,000 ³
CR Lease liability	1,259,200 ⁴
CR Financial liability	200,000 ⁵
CR Gain on rights transferred	240,355 ⁶

1. Total cash received from the buyer-lessor.
2. The retained right-of-use of the asset sold is measured by reference to the previous carrying value of the property. This assumes that the seller-lessee is taking option 1 in the table above for the measurement of the right-of-use asset. The fair value of the property is 1,800,000, whilst the fair value of the leaseback rental is 1,259,000 (i.e. 200,000 less than the repayments that the lessee is required to

make). Therefore, the cost of the property for which control has not passed to the buyer-lessor = $1,000,000 \times 1,259,000/1,800,000 = 699,355$.

3. The previous carrying value of the property is derecognised.
4. Present value of future lease payments is £1,459,200 (£120,000 per year for 18 years, 4.5% annual discount). This includes the difference between the consideration received and the fair value of the property of £200,000 (£2,000,000 – £1,800,000), which is recognised as financial liability. Remaining present value of future lease payments is £1,259,200. In other words, had proceeds on sale been on-market at £1,800,000, then the present value of the leaseback payments would only have been £1,259,000. The proceeds above market on the sale side of the transaction are therefore treated as additional financing.
5. The excess consideration of £200,000 is recognised as additional financing provided by the buyer-lessor to the seller-lessee.
6. The gain on sale is the balancing entry in the transaction, but can be reconciled as follows:

Gain = Proceeds attributable to the portion of the asset for which control is transferred

LESS

Carrying value of the portion of the asset for which control is transferred

Proceeds attributable to the portion of the asset being disposed for which control is transferred:

$$\begin{aligned}
 &= \text{Total proceeds less total amount of financing received} \\
 &= 2,000,000 - 1,459,200 \\
 &= \mathbf{540,800}
 \end{aligned}$$

Carrying value of the portion of the asset being sold for which control is transferred:

$$\begin{aligned}
 &= \text{Carrying value less right-of-use asset retained} \\
 &= 1,000,000 - 699,555 \\
 &= \mathbf{300,445}
 \end{aligned}$$

Therefore, gain on disposal

$$\begin{aligned}
 &= 540,800 - 300,445 \\
 &= \mathbf{240,355}
 \end{aligned}$$

If instead option 2 had been taken, then the right-of-use asset would be initially measured at £1,459,200 (the present value of the annual leaseback payments). The initial double entries would then be:

DR Cash	2,000,000
DR Right-of-use asset	1,459,200
CR PPE (the property sold)	1,000,000
CR Lease liability	1,259,200
CR Financial liability	200,000
CR Gain on rights transferred (liability)	1,000,000

The gain of £1,000,000 is deferred on the statement of financial position and released to the income statement over the 18 year lease term.

BDO comment

SALTs are common for transactions involving real estate. Due to the lessee having to exclude from the calculation of profit on disposal the total consideration attributable to the financing received, the accounting required by FRS 102 will typically result in smaller gains on disposal when recognising the sale side of the transaction.

It should be noted that the carrying value of the asset being sold and leased back must be at its appropriate carrying amount following the application of other sections of FRS 102 prior to the SALT.

Subsequent measurement of lease liability in a SALT

The initial measurement of the lease liability that arises from a SALT is a consequence of how the seller-lessee measures the right-of-use asset and the gain or loss recognised at the date of the transaction. Under option 1 in the table further up in this section, the seller-lessee is required to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. However, FRS 102 does not prescribe a methodology for determining the proportion of the carrying amount of the asset that relates to the right of use retained by the seller-lessee.

The FRS 102 Glossary defines 'lease payments' that are to be included in the measurement of lease liabilities. Such lease payments exclude variable lease payments that do not depend on an index or rate (e.g. payments that depend on a percentage of revenue derived from the asset's use).

To be consistent with this, in case of a SALT involving variable payments that do not depend on an index or rate, while measuring the lease liability, the seller-lessee would exclude variable payments that do not depend on an index or rate. This measurement of lease liability may result in recognition of gain on the right-of-use retained by the seller-lessee, as the SALT would generally be economically structured considering the expected lease payments, including the variable lease payments



Example 9-2 – Sale-and-leaseback transaction with variable payments

Fact pattern:

On 1 January 20X1, Entity A (seller-lessee) sells a piece of machinery to Entity B (buyer-lessor) for consideration of £2,500,000, which is the fair value of the machinery at the date of sale.

The carrying value of the machinery immediately before the sale is £2,000,000.

At the same time as the sale transaction, the seller-lessee enters into a lease contract with the buyer-lessor for use of the machinery, for a period of five years. Lease payments consist of fixed payments of £50,000 per annum and variable payments at 3% of the revenue generated from the use of the machinery. The variable payments are determined to be not in-substance fixed payments.

The transfer of the machinery satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale.

Accordingly, seller-lessee accounts for the transaction as a sale and leaseback.

The interest rate implicit in the lease cannot be readily determined. Seller-lessee's

incremental borrowing rate is 4%.

The seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term.

Scenario 1:

At the commencement of the leaseback, the seller-lessee is able to estimate the revenue for the period of the lease. The estimated revenue at lease commencement is as below:

Year	Revenue (£)
20X1	1,500,000
20X2	1,600,000
20X3	1,650,000
20X4	1,700,000
20X5	1,800,000

Assessment:*A. Determination of proportion of right-of-use retained*

FRS 102 (under option 1 as set out above) requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

FRS 102 does not prescribe a method for determining this proportion.

One possible method is to compare the present value of expected lease payments (including those that are variable) with the fair value of the asset at the date of the transaction.

Following this method, seller-lessee measures the present value of expected lease payments as below:

(Amounts in £)

Year	Fixed lease payment	Estimated revenue	Variable lease payments (3% of estimated revenue)	Total lease payment	Present value (discounted at incremental borrowing rate of 4%)
20X1	50,000	1,500,000	45,000	95,000	91,346
20X2	50,000	1,600,000	48,000	98,000	90,607
20X3	50,000	1,650,000	49,500	99,500	88,455
20X4	50,000	1,700,000	51,000	101,000	86,335
20X5	50,000	1,800,000	54,000	104,000	85,480
				Total	442,223

The seller-lessee arrives at the proportion of the carrying amount of the machinery related to the right-of-use retained to be 17.7%, calculated as [$£442,223$ (present value of expected lease payments) / $£2,500,000$ (fair value of the machinery)].

B. Measurement of right-of-use asset and lease liability at commencement

The lease liability at commencement of the leaseback transaction is measured at $£442,223$, which is the present value of expected lease payments.

The right-of-use asset at commencement is measured at $£353,778$, calculated as $£2,000,000$ (previous carrying amount of the machinery) * 17.7% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 82.3% (1 – 17.7%). The gain on rights transferred is measured at $£411,555$, calculated as $£500,000$ (total gain on sale of the machinery ($£2,500,000 - £2,000,000$)) * 82.3%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash	£2,500,000	
DR Right-of-use asset	£353,778	
CR Machinery		£2,000,000
CR Lease liability		£442,223
CR Gain on rights transferred		£411,555

E.

Scenario 2:

At the commencement of the leaseback, the seller-lessee is not able to estimate the revenue for the period of the lease.

The estimated remaining useful life of the machinery is 20 years.

Assessment:*A. Determination of proportion of right-of-use retained*

FRS 102 (under option 1 as set out above) requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

FRS 102 does not prescribe a method for determining this proportion.

Since the seller-lessee is not able to estimate the revenue for the period of the lease, the method followed in Scenario 1 of estimating expected lease payments cannot be followed.

Considering the facts and circumstances, a possible approach is to compare the lease period (five years to the remaining useful life of the asset (20 years)). Based on this, the proportion of the previous carrying amount of the asset that related to the right-of-use retained by the seller-lessee is 25%.

B. Measurement of right-of-use asset and lease liability at commencement

The right-of-use asset at commencement is measured at £500,000, calculated as £2,000,000 (previous carrying amount of the machinery) * 25% (proportion of the machinery that relates to the right-of-use retained).

The lease liability at commencement of the leaseback transaction is measured at £625,000, calculated as £2,500,000 (fair value of the machinery on the date of the transaction) * 25% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 75% (1 – 25%). The gain on rights transferred is measured at £375,000, calculated as £500,000 (total gain on sale of the machinery (£2,500,000 – £2,000,000) * 75%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash	£2,500,000
DR Right-of-use asset	£500,000
CR Machinery	£2,000,000
CR Lease liability	£625,000
CR Gain on rights transferred	£375,000

E.

As can be seen from the above illustration, the measurement of right-of-use asset and lease liability recognised in a SALT may differ based on facts and circumstances of each case, even though the contractual terms of the lease agreement are the same.



10. Interaction with section 19 Business Combinations and Goodwill

Section 19 *Business Combinations and Goodwill* requires that most assets and liabilities acquired in a business combination be measured at their acquisition date fair values. An exception to this requirement is for leases, where FRS 102 19.19A states:

The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Section 20 Leases in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

- a. leases for which the lease term ends within 12 months of the acquisition date; or*
- b. leases for which the underlying asset is of low value (as described in Section 20 Leases).*

The acquirer shall measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

The following example illustrates the application of these requirements.

Refer Chapter 5.2 for discussion of the discount rate applicable for leases acquired in a business combination.

Example 10.1-1 – Business combination where acquiree is a lessee

Entity A enters into a property lease for a period of eight years on 1 January 20X1, with annual lease payments of £250,000, payable annually in advance. Entity A has an option to extend the lease by two years with annual lease payment of £275,000 during the extension period. At lease commencement, Entity A assesses that it is not reasonably certain to exercise the extension option. The rate implicit in the lease is not readily determinable. Entity A's incremental borrowing rate at the time of lease commencement is 6.5%. Both entities opt to use the incremental borrowing rate (not the obtainable borrowing rate) as the discount rate for this lease

On 1 January 20X4, Entity A is acquired by Entity B. Entity B determines that it is reasonably certain to exercise the extension option. Entity B's incremental borrowing rate at the time of the business combination is 4%. Entity A's incremental borrowing rate at the time of the business combination is 7%. At the time of the business combination, the market rental for the property was £315,000 per annum for a period of seven years.

Assessment

Entity B will measure the lease liability and right-of-use asset at the time of business combination as follows:



A. Measurement of lease liability

Entity B is required to measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date.

Since Entity B determines that it is reasonably certain to exercise the extension option, the lease term is determined to be seven years (five years in the non-cancellable period plus the two year extension option). The lease liability is the present value of lease payments (£250,000 for first five years and £275,000 for the next two years, payable annually in advance), discounted at Entity A's incremental borrowing rate which is 7%. (Refer to Chapter 5.2 for guidance on determination of discount rate). The lease liability is therefore £1,476,118.

B. Measurement of right-of-use asset

Entity B is required to measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms. The market rental for the property at the time of the acquisition is £315,000 per annum. Entity B has acquired the lease on favourable terms as the contractual lease payments are below-market.

Therefore, the right-of-use asset is measured by discounting £315,000 for a period of seven years at a discount rate of 7%, which amounts to £1,816,460.

Alternatively, the right-of-use asset can be measured by adding the present value of rent differential between the market rent and contractual rent to the lease liability.

The difference between the lease liability and the right-of-use asset affects the measurement of goodwill or a bargain purchase gain in the purchase price allocation of the business combination.

The lease liability and the right-of-use asset are subsequently measured by Entity B in accordance with the subsequent measurement requirements of Section 20 Leases.

A practical consequence of applying the requirements of Section 19 *Business Combinations and Goodwill* is that Entity B and Entity A will measure the same lease at different amounts, assuming that Entity A continues to prepare separate financial statements. This will require adjustments on consolidation of Entity A by Entity B on an ongoing basis.



11. Interactions with other sections of FRS 102

The amendments to section 20 Leases have resulted in several consequential amendments to other sections of FRS 102. A summary of the more significant amendments are:

Standard	Effect of Amendments
<i>Section 35 Transition to this FRS</i>	<ul style="list-style-type: none"> ▶ In respect of initial measurement, an entity generally: <ul style="list-style-type: none"> – Measures the lease liability as the present value of remaining lease payments discounted using the lessee's incremental or obtainable borrowing rate at the date of transition; – Measures the right-of-use asset at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments. ▶ However, a right-of-use asset for a lease that meets the definition of investment property would be measured at fair value on transition. ▶ An election is available whereby instead of the general initial measurement guidance above, a lessee applying IFRS 16 Leases immediately prior to the date of transition to FRS 102 may use the lease liability and right-of-use asset calculated under IFRS 16 as the lease liability and right-of-use asset on the date of transition. A lessee making this election shall disclose that fact and shall apply it to all of its leases. In this case, a lessee may rely on its previous assessment of whether right-of-use assets are impaired at the date of transition, rather than applying Section 27 Impairment of Assets at that date. ▶ An entity may assess whether a contract existing at the date of transition contains a lease by applying paragraphs FRS 20.15 to 20.18 on the basis of facts and circumstances existing at that date, rather than at the commencement date of the lease. ▶ A lessee may also use several other simplifications on a lease-by-lease basis: <ul style="list-style-type: none"> – Use a single discount rate for a reasonably similar portfolio of leases; – Elect not to recognise leases on the statement of financial position that terminate within 12 months of the date of transition; – Elect not to recognise leases on the statement of financial position where the underlying asset is of low value; – Elect to use hindsight (e.g. in determining the lease term if options exist). <p>Please note that this guidance relates to transition to FRS 102 as a whole, not transition to the new lease requirements for entities already applying FRS 102, which we have covered in a separate section.</p>
<i>Section 19 Business Combinations and Goodwill</i>	<ul style="list-style-type: none"> ▶ Refer to section 10 above
<i>Section 11 Basic Financial Instruments</i>	<ul style="list-style-type: none"> ▶ Clarifies that the derecognition guidance in Section 11 Basic Financial Instruments applies to lease liabilities. This was already the case for payables recognised by a lessee under a finance lease, under the previous model.

Standard	Effect of Amendments
<i>Section 7 Statement of Cash Flows</i>	<ul style="list-style-type: none"> ▶ Cash payments by a lessee for the principal portion of the lease liability are included in cash flows from financing activities. ▶ Cash payments by a lessee for the interest portion of a lease liability qualify as interest paid and are therefore subject to the entity's choice of treatment between operating and financing activities. ▶ Payments for short-term leases, payments for leases of low value assets and variable lease payments not included in the measurement of the lease liability are included in cash flows from operating activities.
<i>Section 16 Investment Property</i>	<ul style="list-style-type: none"> ▶ Significant editorial amendments to reflect that leased right-of-use assets may meet the definition of investment property.
<i>Section 25 Borrowing Costs</i>	<ul style="list-style-type: none"> ▶ Clarified that interest expense on lease liabilities falls within the definition of borrowing costs.
<i>Section 34:12-16 Service Concession Arrangements</i>	<ul style="list-style-type: none"> ▶ Accounting by grantors follows the guidance of Section 20 Leases.
<i>Section 34:17-33 Financial Institutions</i>	<ul style="list-style-type: none"> ▶ Financial institutions are required to prepare a maturity analysis for financial liabilities at undiscounted amounts. Lease liabilities must be presented separately in this analysis.
<i>Section 34:64-74 Incoming Resources from Non-Exchange Transactions</i>	<ul style="list-style-type: none"> ▶ For public benefit entities, when a lease contains a non-exchange transaction (eg when the lease payments are significantly below market rents), the incoming resources shall be accounted for as a receipt of resources that form part of the cost of the right-of-use asset.



12. Effective date and transition

This section discusses the transitional requirements for an entity that already applies FRS 102.

12.1 Effective date

Section 20 is effective for periods commencing on or after 1 January 2026. Earlier adoption is permitted, provided all the Periodic Review 2024 amendments are applied at the same time.

The date of initial application is the beginning of the annual reporting period in which an entity first applies the Periodic Review 2024 amendments.

12.2 General requirements

Lessees are required to apply a modified retrospective approach on transition to revised Section 20. Under this approach, the lessee measures the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate or obtainable borrowing rate.

The lessee recognises a right-of-use asset equal to the current lease liability (adjusted for any previously recognised prepayment or accrual of lease payments) unless the entity applies the IFRS 16 expedient discussed below.

FRS 102 1.51(b) requires the lessee to use information readily available to it at the date of initial application to determine whether, at the commencement date or the date of the most recent lease modification, the lessor provided the lessee with incoming resources from a **government grant** or (for a public benefit entity only) a **non-exchange transaction** as described in FRS 102 20.35. If so, the lessee measures the non-exchange element at the date of initial application and adjusts the right-of-use asset accordingly.

A lessee must not restate its comparative figures and, instead, it recognises the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings on the date of initial application.



Example 12.2.1 Accounting for right of use assets on the date of initial application

Entity A entered into an eight-year lease of a property on 1 January 20X4. The lease provides for a rent-free period for the first two years, followed by annual lease payments of CU1.2 million for the remaining six years, payable at the end of each year. Before the adoption of the revised lease accounting requirements in FRS 102 Section 20, the lease was classified as an operating lease and the total lease cost was recognised on a straight-line basis over the lease term. On 31 December 20X5, the entity had recognised a lease incentive of CU1.8 million on the balance sheet. The lease agreement requires the entity to reinstate all alterations to the property and return the property in a state in which it was first received by Entity A. Entity A has a provision for the cost of removal of alterations of CU600,000 on the balance sheet as at 31 December 20X5, the provision was capitalised as part of leasehold improvement at the commencement date of the lease on 1 January 20X4. The entity's obtainable borrowing rate at 1 January 20X6 is 5%.

Assessment

At the date of initial application (1 January 20X6), the lessee measures the lease liability at the present value of the remaining six payments of CU 1,200,000, discounted at the obtainable borrowing rate of 5% per annum, which is CU 6,090,830.

Entity A initially measures the right of use asset at an amount equal to the lease liability adjusted for the lease incentives recognised on the balance sheet before the date of initial application as required by FRS 102 1.51(b).

The entries required to record this transaction are as follows:

To recognise the initial value of right of use asset and lease liability as at date of initial application

DR right of use asset	CU 4,290,830*
DR Lease incentive	CU 1,800,000
CR lease liabilities	CU 6,090,830

*Lease liability of CU 6,090,830 less lease incentive of CU 1,800,000

Entity A does not make adjustment for the cost of restoration as the restoration cost is not a prepaid or accrued lease payment recognised on the balance sheet immediately before the date of initial application.

12.3 Transitional provisions for lessees

12.3.1 Definition of a lease

As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted to apply the requirements of the revised Section 20 to contracts that were previously identified as containing a lease, and not to apply the requirements of the revised Section 20 to contracts that were not previously identified as containing a lease. This practical expedient is sometimes referred to as 'grandfathering'.

If an entity chooses this practical expedient, it shall disclose that fact and shall apply the practical expedient to all of its contracts.

It is important to note that this practical expedient determines which existing contracts will be deemed to be within the scope of the new lease accounting model and which will be within the scopes of other sections of the standard. It does not allow the entity to continue to apply the old lease accounting model.

12.3.2 IFRS 16 practical expedient

FRS 102 1.48 provides a practical expedient, for a lessee to measure the carrying amounts of its lease liabilities and right of use assets at the date of initial application at amounts previously measured in accordance with IFRS 16 for the purposes of inclusion in IFRS consolidated financial statements. If an entity chooses this practical expedient, it discloses that fact and applies the practical expedient to all of its leases.

FRS 102 Factsheet 9 (Initial application of the Periodic Review 2024) clarified that calculations made 'for the purposes of including the entity in consolidated financial statements prepared in accordance with IFRS Accounting Standards' would generally include calculations made which are then subsequently eliminated on consolidation, and so the existence of leases which are eliminated on consolidation would not necessarily preclude the use of the IFRS 16 option.



Example 12.3.2.1 Applying IFRS 16 practical expedient

A parent Entity A prepares consolidated financial statements under FRS 102. Its overseas subsidiary (Entity S) prepares its individual financial statements under IFRS Accounting Standards and has applied IFRS 16 Leases.

On transition to the revised lease accounting requirements in Section 20 of FRS 102, can the parent Entity A apply paragraph 1.48 by analogy and use the lease balances (right-of-use assets and lease liabilities) already calculated by the subsidiary (Entity S) under IFRS 16 for the purposes of consolidation?

Assessment

No. The parent cannot apply FRS 102.1.48 by analogy in this situation and is not permitted to use the lease balances calculated under IFRS 16 in its consolidated financial statements as these are not calculated for the purpose of including the entity in consolidated financial statements.

Instead, on transition to the revised Section 20, the parent must recognise lease liabilities and right-of-use assets in the consolidated financial statements based on amounts calculated in accordance with FRS 102 (including the relevant transitional provisions), even where the subsidiary has already recognised leases under IFRS 16 in its own financial statements

12.3.3 Leases previously classified as operating leases

Low value leases: A lessee is not required to make any adjustments on transition for leases for which the underlying asset is of low-value that will be accounted for using the practical expedient for leases of low-value assets.

Short term leases: If a lease ends within 12 months of the date of initial application, as a practical expedient, a lessee may account for it in the same way as a short-term lease in accordance with paragraph 20.6.

Investment property: A lessee is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in section 16.

The lessee accounts for the right-of-use asset at fair value and the lease liability arising from those leases applying Section 16 and the revised Section 20, respectively, from the date of initial application.

Practical expedients

The following practical expedients apply to leases previously classified as operating leases, and may be applied on a lease-by-lease basis:

- ▶ A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).
- ▶ Hindsight may be used in assessing the terms of a lease, such as in assessing whether an extension or termination option is likely to be exercised when determining the lease term.
- ▶ Instead of applying Section 27 to right-of-use assets at the date of initial application, in line with FRS 102 1.51(c), an entity may rely upon its previous

assessment of whether leases are onerous (applying Section 21 Provisions and Contingencies) immediately before the date of initial application. If applying this practical expedient, an entity may adjust the right-of-use asset by the amount of any onerous lease provision recognised immediately prior to the date of initial application.

12.3.4 Leases previously classified as finance leases

On the date of initial application, an entity is required to recognise a lease liability and a right-of-use asset at an amount equal to the carrying value of the finance lease liability and the leased asset recognised immediately before transition. As a result, no adjustment is made to retained earnings for leases that were previously classified as finance leases.

The subsequent measurement of leases previously classified as finance leases may differ from that which would have been measured using the old lease accounting model, for example if there are lease modifications after the date of initial application.

12.3.5 Transitional provisions for lessors

An entity makes no adjustment on initial application for leases in which it is a lessor (except that an intermediate lessor reassesses subleases that were previously classified as operating leases) and applies the revised Section 20 from the date of initial application.

An intermediate lessor re-assesses operating sub-leases on the basis of the remaining contractual terms and conditions of the head lease and the sub-lease at the date of initial application. If former operating sub-leases are now classified as finance leases, the lessor accounts for the sub-lease as a new finance lease entered into on the date of initial application.

12.3.6 Transitional provisions for sale and leaseback

An entity does not re-assess sale and leaseback transactions entered into before the date of initial application to determine whether or not the sale fulfilled the conditions of revised section 23 (revenue from contracts with customers) to be accounted for as a sale.

For a finance leaseback, the seller-lessee continues to amortise any gain on sale over the term of the lease, unless it applies the IFRS 16 practical expedient.

For an operating leaseback, the seller-lessee accounts for any deferred gain or loss due to off-market terms recognised on the balance sheet immediately before initial application as an adjustment to the leaseback right-of-use asset, unless it applies the IFRS 16 practical expedient.

12.3.7 Disclosure

Section 10 (Accounting policies, Estimates and Errors) includes certain disclosure requirements when there is a change in accounting policy, some of which apply in respect of the changes made to Section 20. As set out in FRS 102 1.44, an entity is exempt from the disclosure requirements of paragraphs 10.13(b) to 10.13(d) and, instead, shall disclose the amount of the adjustment to profit or loss in the current period as a result of applying the revised section 20 or an explanation if it is impracticable to do so.

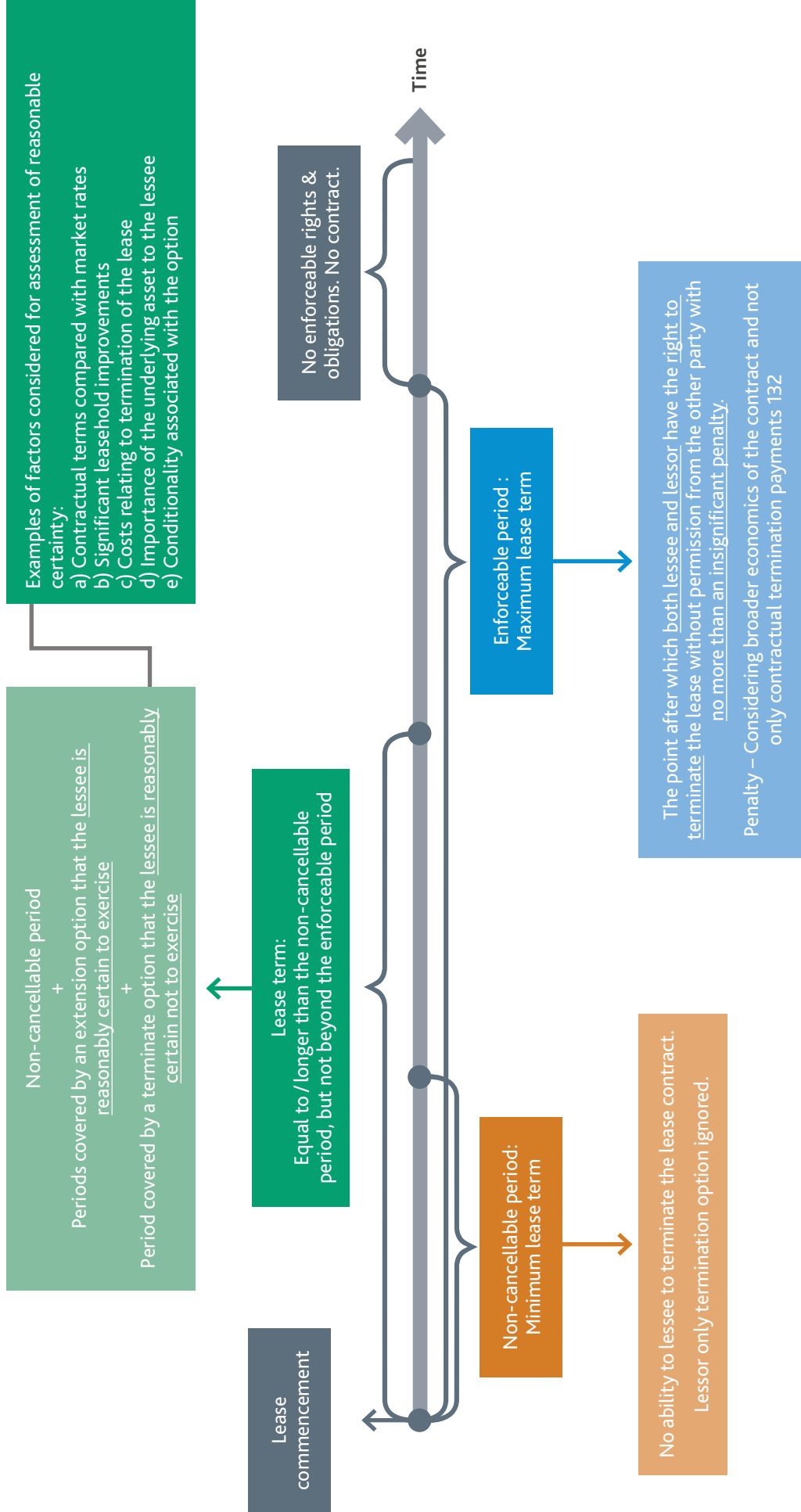


Appendix A - Definitions

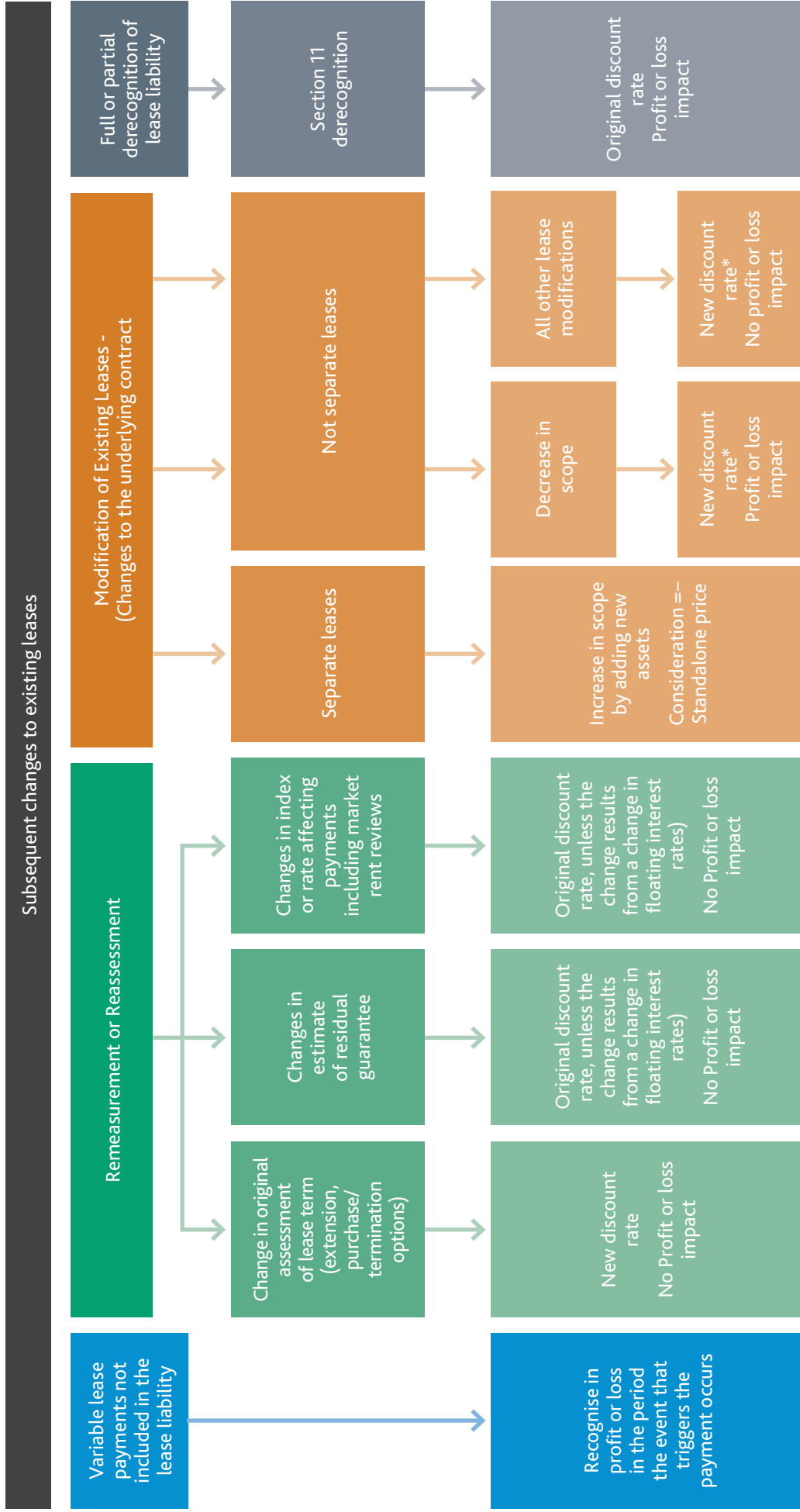
commencement date of the lease (commencement date)	The date on which a lessor makes an underlying asset available for use by a lessee.
contract	An agreement between two or more parties that creates enforceable rights and obligations.
effective date of the modification	The date when both parties agree to a lease modification .
fair value	For the purpose of applying the lessor accounting requirements in FRS 102, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
finance lease	A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset .
gross investment in the lease	The aggregate of: (a) the lease payments receivable by a lessor under a finance lease ; and (b) any unguaranteed residual value accruing to the lessor.
inception date of the lease (inception date)	The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
initial direct costs	Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease .
interest rate implicit in the lease	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.
lease	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
lease incentives	Payments made by a lessor to a lessee associated with a lease , or the reimbursement or assumption by a lessor of costs of a lessee.
lease modification	A change in the scope of a lease , or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets , or extending or shortening the contractual lease term).
lease payments	Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term , comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives ; (b) variable lease payments that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) payments of penalties for terminating the lease , if the lease term reflects the lessee exercising an option to terminate the lease.

lease payments (continued)	<p>For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.</p> <p>For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.</p>
lease term	<p>The aggregate of:</p> <ul style="list-style-type: none"> (a) the non-cancellable period of a lease; (b) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and (c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
lessee's incremental borrowing rate	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.
lessee's obtainable 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.
net investment in the lease	The gross investment in the lease discounted at the interest rate implicit in the lease .
operating lease	A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset .
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
residual value guarantee	A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.
right-of-use asset	An asset that represents a lessee's right to use an underlying asset for the lease term .
short-term lease	A lease that, at the commencement date , has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.
social donation lease	Lease arrangements which contain a non-exchange component since the payments are below market rent 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.
underlying asset	An asset that is the subject of a lease , for which the right to use that asset has been provided by a lessor to a lessee.
unearned finance income	The difference between: <ul style="list-style-type: none"> (a) the gross investment in the lease; and (b) the net investment in the lease.
unguaranteed residual value	That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.
useful life	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Appendix B - Lease term assessment flow chart



Appendix C - Subsequent changes to existing leases



* Except where

- the lease modification decreases the scope of the lease by removing the right to use one or more underlying assets, and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope

- the additional consideration from the lease modification is insignificant to the total consideration of the original lease; or

- the lease modification decreases the consideration payable for the remaining terms of the lease, but does not decrease the scope of the lease by removing the right to use one or more underlying assets where an unchanged discount rate can be used subject to FRS 102.20.72.

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