HaysMac

FRS 102: All change for lease accounting

For accounting periods beginning on or after 1 January 2026

1. Introduction: Why lease accounting is changing

The Financial Reporting Council ("FRC") has made major revisions to sections of FRS 102, "The Financial Reporting Standard applicable in the UK and Republic of Ireland" as part of the "Periodic Review 2024".

The changes to the standard do not significantly alter the accounting for leases from the perspective a lessor and so this factsheet focuses on the impact on lessee accounting arising from the new Section 20 "Leases".

For lessees, the distinction between operating and finance leases is removed and, subject to limited exemptions (see Stage 3 below), leased assets and lease liabilities will be included on balance sheet, similar to the finance lease model under the existing version of the standard. The intention of these changes is to provide enhanced and more transparent information for the users of financial statements by better reflecting the assets controlled by the entity and the related liabilities.

This change aligns with, but isn't identical to, the treatment of leases under IFRS 16 "Leases", the international accounting standard. FRS 102 includes some important simplifications and "practical expedients" designed to make initial recognition of the requirements simpler to apply than IFRS 16. The most significant are discussed within this factsheet.

The revised standard is effective for accounting periods beginning on or after 1 January 2026, with early adoption permitted.

2. The New Lease Accounting Model

FRS 102 defines a lease as "*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*".

Section 20 applies to all leases aside for those used in certain specialised activities (e.g. leases to explore for non-regenerative resources and biological assets), service concession arrangements (which are in scope of Section 34 of FRS 102), licences of intellectual property (which are in scope of Section 23 of FRS 102), rights under licensing agreements (these are in scope of section 18 of FRS 102) and leases that could lead to a loss to the lessor or lessee as a result of non typical contractual terms. Most leases are therefore in scope.

Unless the exemptions explained in Stage 3 below apply, the new model requires lessees to recognise a Right-of-Use asset representing the leased assets they control and a corresponding lease liability for the financial commitment. The standard explains how lessees should apply the new requirements to new leases. These can be summarised in five stages (overleaf).

Stage 1: Entities are required to assess whether a contract is or contains, a lease

Stage 2: Entities should determine the lease term

Stage 3: Entities should consider if the leases are exempt

Stage 4: Entities must measure the lease liability

Stage 5: Entities calculate the Right-of-Use asset

Stage 1: Identify whether a contract is or contains, a lease

Section 20 explains that "*contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration*". The right to control an asset gives the customer both the right to direct the use of an identified asset and the right to obtain "substantially all" the economic benefits from its use. The economic benefits can be obtained directly or indirectly, including subleasing the asset.

Example – Contracts and leases

Tex's Trucks Limited, a logistics company enters a three-year agreement to use one particular articulated truck, identified by registration number and VIN. Because the contract specifies the exact truck to be supplied, the company has exclusive use of the truck throughout the term and determines how, when, and where the truck is used this meets the definition of a lease.

In a similar scenario Tex's Trucks may contract with another haulage provider to provide additional daily delivery capacity between two distribution hubs for three years. In this arrangement the other provider uses its fleet, selecting whichever of its trucks are available daily, while trucks are swapped between routes and are not dedicated to Tex's business so Tex cannot choose which truck carries its goods, the other provider controls routing, scheduling, and asset deployment. This arrangement would not be a lease as there is no identified asset and Tex's Trucks does not control the use of any particular vehicle, and the contract conveys a transportation service, not the right to use a truck.

Stage 2: Determine the lease term

Management shall determine the lease term as the aggregate of:

(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; and

+

(c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

Factors to consider in the assessment of whether an option in a lease is reasonably certain to be exercised include:

- the contractual terms and conditions compared with market rates;
- significant leasehold improvements expected to have significant economic benefit when the option becomes exercisable;
- the costs relating to the termination of the lease;
- the importance of the underlying asset to the lessee's operations; and
- conditionality associated with exercising the option.

Example** – **Determining the lease term

Pep's Pubs Limited enters into a lease for a new venue with a non cancellable period of five years, an optional three year renewal period and no early termination option. The site is in a prime, profitable location in a city centre, and the company has invested significantly in leasehold improvements which are expected to have a useful economic life of ten years, while relocation costs would be high and there are no reasonable alternative sites in the key city centre location.

- Given the significant expense on improvements, which are expected to last for a long term, together with the importance of the site, it appears reasonably certain that the option to extend will be taken. The lease term should include the option period.

Stage 3: Consider if the leases are exempt from on balance sheet recognition

On balance sheet recognition is not required for:

1. Short term leases (defined by the standard as leases with a lease term of 12 months or less, and excluding any lease with a purchase option); and
2. Leases for low value assets (explained in the standard as certain discrete assets with low values regardless of materiality to the lessee. In para 20.11 the standard provides examples of assets that are not of low value including cars, vans and trucks, production equipment and land and buildings).

The Charity SORP does provide examples of low value assets in its guidance with the examples including "personal computers, tablet devices, small items of office furniture and telephones". An asset can be of "low value" only if: (a) the lessee can benefit from use of the asset on its own or together with other resources that are readily available to the lessee; and (b) the asset is not highly dependent on, or highly interrelated with, other assets.

Where these exemptions are available, lessees will continue to treat the lease payments as expenses recognised over the lease term.

Examples of assets that are not of low value

- Cars, vans, buses, coaches, trams, trucks and lorries
- Cranes, excavators, loaders and bulldozers
- Forklift trucks and similar
- Tractors, harvesters and related attachments
- Boats and ships
- Aircraft and aero engines
- Land and buildings
- Production line equipment

Stage 4: Measure the lease liability

At the start of the lease, a lessee is required to calculate the lease liability at the present value of:

- The fixed payments.
- Any amounts expected to be payable by the lessee under residual value guarantees.
- Variable payments linked to an index or rate included in the contract that are not paid at that date.
- Exercise price of purchase options if reasonably certain to be exercised.
- Any penalty payments for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease

Fixed payments

\+

Variable lease payments that depend on an index or a rate

\+

Residual value guarantees

\+

Exercise price of purchase options

\+

Penalty payments for terminating the lease

=

Initial value of the lease liability

Excluded from the calculation of the lease liability are:

- Any variable lease payments linked to future performance or use of the asset, for example turnover based lease payments.
- Payments for non-lease components of the contract (unless the practical expedient to combine lease and non-lease components has been followed)
- The impact of lease incentives received which do not reduce the lease liability but are deducted from the Right-of-Use asset

The lease payments should be discounted using the interest rate implicit in the lease, if that rate can be readily determined. It can be difficult for the lessee to readily determine the interest rate implicit in the lease, for example in property leases as a lessee will not have sufficient information available, such as the lessor's initial direct costs, or the unguaranteed residual value the lessor has assumed when pricing the lease. However, in other cases it will be easier, in which case it must be used. For example, for leases of vehicles the interest rate implicit in the lease is more likely to be readily determinable.

However, if the rate implicit in the lease cannot be readily determined, the lessee can choose, on a lease-by-lease basis, to apply either the lessee's incremental borrowing rate (interest rate 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) or the lessee's obtainable borrowing rate (interest rate 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).

Example – Calculating a lease liability

Arnie's Apples Limited leases an office under the following terms:

- **Lease term:** 5 years
- **Annual lease payments:** £120,000
- **Incremental borrowing rate:** 6%

The lease liability will be the annual payments discounted using the incremental borrowing rate of 6% which over years is £505,000 (PV annuity factor at 6% for 5 years ≈ 4.21, £120,000 x 4.21)

Stage 5: Calculate the Right-of-Use asset

At the start of the lease, lessees are required to measure the Right-of-Use asset at cost. Cost comprises:

Initial value of the lease liability (see Stage 4)

+

Any lease payments made at or before the start date less any lease incentives received

+

Any initial direct costs incurred by the lease

+

Any provision recognised for dismantling or restoring the asset

Lessees are required to recognise the costs above as part of the cost of the right-of-use asset when the lessee incurs an obligation for those costs. This may occur at the commencement date of the lease or subsequently.

Note the restoration provision is discounted to present value using a rate reflecting the time value of money and relevant risks.

Example – Calculating a Right-of-Use asset

As in the previous example Arnie's Apples Limited leases an office under the terms outlined before. The following facts are also relevant:

- **Initial direct costs:** £15,000
- **Restoration cost at end of Year 5:** £50,000
- **Lease incentive:** Landlord provides a £20,000 upfront incentive (e.g., cash rebate) at commencement

The lease liability will be the annual payments discounted using the incremental borrowing rate of 6% which over years is £505,000 (PV annuity factor at 6% for 5 years ≈ 4.21, £120,000 x 4.21)

The restoration provision – being the future cost of restoring the office is forecast to be £50,000 at the end of year 5. Accordingly, a provision is calculated as £37,000. The provision is recognised as a separate liability and cost added to the Right-of-Use asset.

The initial direct costs of £15,000 are added to the Right-of-Use asset and the lease incentive of £20,000 deducted. Giving a Right-of-Use asset of: £537,000 (being £505,000 + £37,000 + £15,000 - £20,000)

3. Key Areas of New Guidance

Supporting the introduction of the on-balance sheet accounting model for lessees summarised in the five stages above, the new Section 20 includes new rules or guidance on various lease related matters. These include:

3.1 Differences to IFRS

Although the revised FRS 102 section 20 is aligned with the principles of IFRS 16, it is not identical to the international standards and lessees comfortable with the requirements of IFRS 16 should familiarise themselves with the differences. The principal differences are:

Initial application – IFRS 16 gave lessees an option to apply the new requirements fully retrospectively (requiring the restatement of comparatives) or the use a modified retrospective approach. FRS 102 requires the modified retrospective approach unless an expedient applies (see Section 4 below for more on initial application).

Discount rate in lease liability calculations – IFRS 16 requires the use of an entity's Incremental Borrowing Rate ("IBR") if the implicit interest rate can not be determined. FRS 102 allows the Obtainable Borrowing Rate ("OBR") which should be easier to determine than the IBR.

Low value assets – IFRS 16 provides examples of low value assets while FRS 102 provides examples of assets that would not be low value assets. The result is that FRS 102 is more permissive and allows greater flexibility and judgement in the assessment by lessees of what assets are low value. However, it is important to note that low value assets will not necessarily be any assets that are not listed specifically in FRS102 – judgment is still required and management will need to be able to justify their assessment of which assets qualify as low value.

3.2 Lease modifications

A lease modification is defined in the glossary of FRS 102 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 (e.g. adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)."*

Lease modifications are accounted for as separate leases if the modification both increases the scope of the lease and the consideration for the lease increases by an amount proportionate with the stand alone price for the increase in scope.

For those lease modifications which are not accounted for as separate leases the Right-of-Use asset and lease liability are remeasured.

3.3 Sale and leaseback

Prior to the amendments to FRS 102, a seller lessee distinguished between a sale and finance leaseback and a sale and operating leaseback. Under the revised standard, the seller lessee must first assess whether the transfer qualifies as a sale in accordance with Section 23. If the transaction meets the definition of a sale, the seller lessee allocates the arrangement between the right of use asset arising from the leaseback—representing the rights retained—and the rights over the underlying asset transferred to the buyer lessor.

As a result, the seller lessee recognises only the portion of any gain or loss that relates to the rights transferred to the buyer lessor. This differs from the previous requirements for sale and operating leasebacks, where the full gain or loss (assuming market terms) was recognised immediately in profit or loss.

3.4 Lessors

The requirements for lessors have not been changed significantly. A lessor continues to classify its leases as operating leases or finance leases and accounts for these two types of lease in essentially the same way as under the previous edition of FRS 102 (January 2022). Entities that are sub-lessors may, however, see some significant changes to how leases are classified and therefore accounted for, due to the interaction of lessor requirements with the amended requirements for lessees.

3.5 Presentation and disclosure in the financial statements

A lessee is required either to present in the statement of financial position, or to disclose in the notes:

- Right-of-use assets separately from other assets (aside from those which are investment property). If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and disclose which line items in the statement of financial position include those right-of-use assets.
- Lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

While not as onerous as IFRS 16, the new disclosure requirements of Section 20 are significantly longer than previous disclosure requirements for lessees, with the objective of providing the users of financial statements more transparent and deeper information to allow them to better understand an entity's leasing activities and their impact on its financial position, financial performance and cash flows.

The recognition of lease liabilities will also mean that that lessees that previously did not include reconciliations of net debt to support their cash flow statements will need to prepare one for the first time.

4. Initial Application of the New Requirements

Lessees are required to apply a "modified retrospective" approach on transition to revised Section 20. This means that 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 (the beginning of the annual reporting period in which an entity first applies the FRS 102 2024 amendments).

Under the modified retrospective approach, an entity measures its right-of-use assets and lease liabilities at the date of initial application. Under this approach comparatives are not restated with any cumulative effect of initial application of the amendments recognised as an adjustment to opening equity.

This differs from the initial application requirements of IFRS16, which allows an accounting policy choice between modified retrospective and full retrospective application. The revised FRS 102 also provides a number of "practical expedients" to simplify initial implementation of the new standard these include:

Lease identification exemption – Entities are 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.

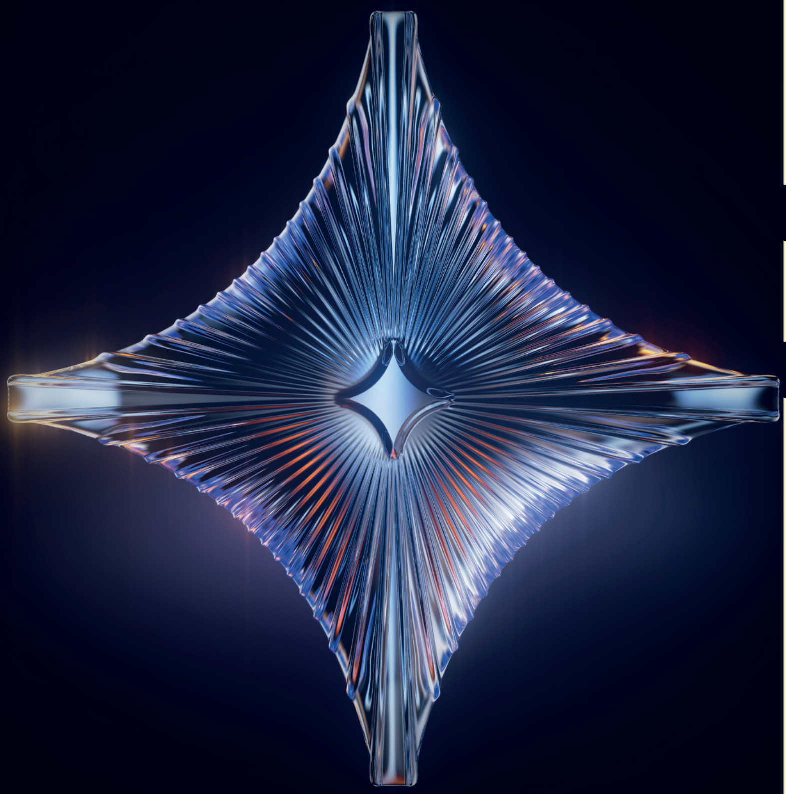
IFRS Group simplification – Where a lessee is part of a group preparing IFRS compliant group financial statements they may recognise at the date of initial application, the carrying amounts as at that date of its lease liabilities and right-of-use assets calculated under IFRS 16 Leases for the purposes of including the entity in consolidated financial statements.

Calculation simplification - For each lease previously classified as an operating lease a lessee shall recognise a lease liability at the date of initial application. However, the lease liability will be measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate or lessee's obtainable borrowing rate for each lease at the date of initial application and the associated right-of-use asset at an amount equal to the lease liability, adjusted only by the amount of any prepaid or accrued lease payments immediately before the date of initial application.

5. Key Impacts and Practical Tips for Preparers of financial statements

The impact of the changes to Section 20, will of course be different for each entity, reflecting variables such as the nature of the industry, the type of assets leased, the detailed contract terms, the normal duration of lease contracts used, standard industry business practices, commercial and operational factors.

Management teams will need to be aware of the potentially significant impacts of the new Section 20 on reported debt, EBITDA and profitability and consider how those in turn affect the entity and its stakeholders.



There are however, some practical tips to follow in order to prepare for the changes:

Contract Review and Classification

- Ensure listings of leases are complete and up to date
- Review all arrangements for contracts that may include leases
- Identify consideration, and assess and evaluate any complex terms including variable consideration, or contract modification terms.

Systems and Processes

- Ensure details of new or revised leases are captured to ensure calculation of the RoU and liabilities

Internal Reporting

- Consider and assess impact on performance measures such as EBITDA or Profit.
- Consider and assess impact on balance sheet, net debt and key ratios
- Ensure that management accounts and other internal financial reports such as budgets include the impact of the changes

Internal Training & Governance

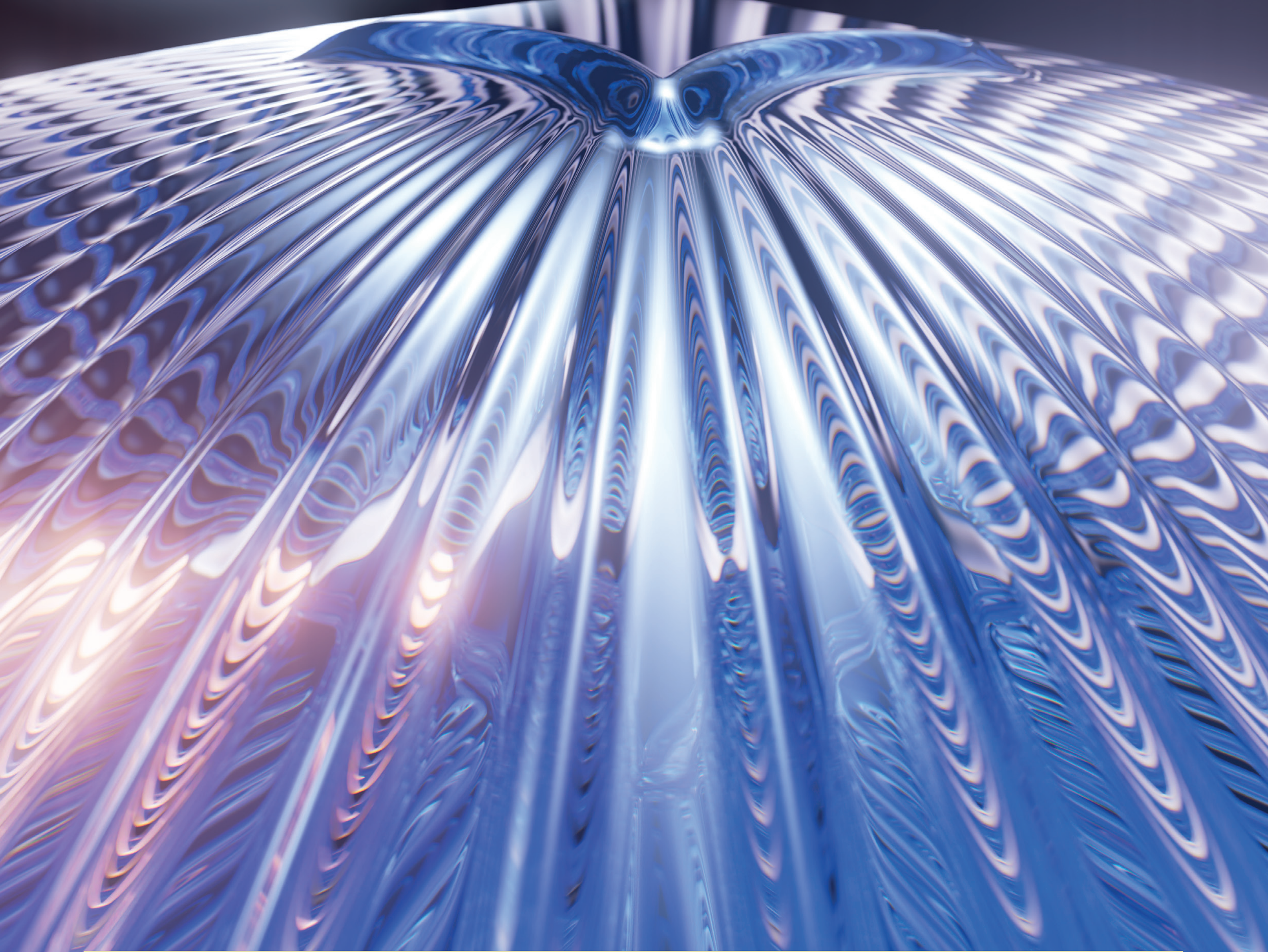
- Train finance teams on the new requirements

Communication with Stakeholders

- Explain expected changes on performance measures net debt and key ratios to management, lenders, and investors.
- Consider how to explain the impacts and lack of comparability between years in the financial statements where the modified retrospective approach to initial application is taken.
- Consider impacts on financing covenants and remuneration metrics (including bonus and share based payment schemes) and discuss with relevant stakeholders.

Tax

- Consider the tax effects and discuss with your advisors where complex or material



HaysMac

Tom Stock
Partner, Head of Audit Technical
T +44 20 7969 5662
E tstock@haysmac.com

10 Queen Street Place
London EC4R 1AG

T 020 7969 5500
E marketing@haysmac.com

haysmac.com

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