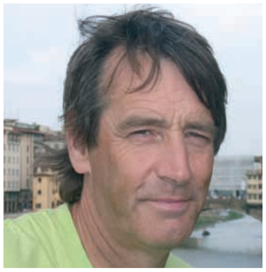

Lease Accounting under FRS 102

Robert Kirk summarises the key accounting issues facing lessees under FRS 102.

Robert Kirk CPA is Professor of Financial Reporting at the University of Ulster. Robert is also author of CPA Ireland Skillnet's recent publication *A New Era for Irish & UK GAAP – A Quick Reference Guide to FRS 102* which is available free of charge to CPA Members on www.cpaireland.ie.

Section 20 of FRS 102 covers the accounting treatment of leases for both lessees and lessors and in this issue I would like to summarise the key accounting issues that face lessees under the standard.

The rules are very similar to SSAP 21 *Leasing and Hire Purchase Contracts* in that FRS 102 artificially distinguishes finance from operating leases and requires the lessee to capitalise the former leases as assets on the Balance Sheet whilst at the same time recording the obligations due to the finance company (lessor) as liabilities. Operating leases are treated as annual rental expenses in the profit and loss account of lessees.

Finance v Operating leases

The decision as to whether a lease is finance or operating can only be made at the inception of the lease. Although under the transitional rules in Section 35 a company may elect to determine whether an arrangement existing at the date of transition to FRS 102 contains a lease on the basis of facts and circumstances existing at that date, rather than when the arrangement was entered into.

A finance lease can only be created if it transfers substantially all the risks and rewards incidental to ownership to the lessee. Unlike the bright line 90% test which exists in SSAP 21 there is more subjective judgement required in deciding what is a finance lease. FRS 102 provides examples which suggest that a finance lease has been created. These include:

(a) A legal transfer by the end of the contract i.e. a hire purchase agreement;

(b) An option to purchase the asset at a bargain price;

(c) A lease term that covers a substantial part of an asset's life;

(d) At its inception the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset; and

(e) A leased asset that is specialised and really can only be used by the lessee.

Accounting for Finance leases in lessees financial statements

If a finance lease is created then both the asset and liability are recognised at the lower of the present value of the minimum lease payments and the fair value of the asset. Each payment made by the lessee is then apportioned between the interest expense and the reduction in the liability. The interest charge, however, must reflect the fact that the principal owed to the lessor is reducing with each payment. That means that a constant rate of interest on the outstanding liability must be charged each period – effectively ruling out the use of the straight line method and ensuring that either the sum of the digits or the more accurate actuarial method must be adopted.

In addition, the finance lease asset must be depreciated over the shorter of the lease term (including both primary and secondary periods) and the useful life of the leased asset.

Example 1

On 1 January 2015 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of ten years, at the end of which it is expected to have no value. At the inception of the lease, the fair value (cash cost) of the machine is €100,000.

On 31 December of each of the first four years of the lease term the lessee is required to pay the lessor €23,000. At the end of the lease term ownership of the machine passes to the lessee upon payment of the final lease payment of €23,539.

The interest rate implicit in the lease is 5% per year, which approximates the lessee's incremental borrowing rate.

In this example, in accordance with Section 17 *Property, Plant and Equipment* the entity depreciates the machine on the straight-line basis over its expected ten-year useful life.

Suggested accounting treatment
Extract from the lessee's statement of financial position at 31 December 2017:

	Notes	2017	2016
		€	€
ASSETS			
Non-current assets			
Property, plant and equipment	8	70,000	80,000
EQUITY AND LIABILITIES			
Non-current liabilities			
Long term borrowings	12	22,417	43,255
Current liabilities			
Current portion of long term borrowings	12	20,838	19,845

Extract from the lessee's statement of comprehensive income at 31 December 2017:

	Notes	2017	2016
		€	€
Finance costs		(3,155)	(4,100)

Extract from the lessee's statement of cash flows at 31 December 2017:

	Notes	2017	2016
		€	€
Cash flow from operating activities			
Interest paid		(3,155)	(4,100)
Cash flow from financing activities			
Payment of finance lease liabilities		(19,845)	(18,900)

Extract from the lessee's notes to the financial statements for the year ended 31 December 2017

Note 1 Accounting policies

Leases

At its inception, a lease is classified as either a finance lease or an operating lease. Finance leases transfer substantially all the risks and rewards of ownership from the lessor to the lessee. All other leases are classified as operating leases.

At the commencement of the lease term, the rights of use held under finance leases are recognised as items of property, plant and equipment at the fair value of the leased property or, if lower, the present value of the minimum lease payments, determined at the inception of the lease. A corresponding liability is recognised for the obligations under a finance lease to make lease payments to the lessor.

Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability (i.e. the effective interest method). Contingent rents are recognised as expenses in the determination of profit or loss of the period in which they are incurred.

Note 8 Property, plant and equipment

Machine	***2017***
1 January	***€***
Cost	100,000
Accumulated depreciation	(20,000)
Carrying amount	80,000
Depreciation	(10,000)
31 December	70,000

The machine is held under a finance lease (see note 12).

Note 12 Long-term borrowings

Finance lease obligation

The entity holds a machine with an estimated useful life of ten years under a five-year finance lease. At the end of the lease term, when the final lease payment is made, ownership of the machine passes to the entity. Information about the obligation to make future lease payments is set out below.

	2017	2016
	€	€
Future minimum lease payments fall due as follows:		
– within one year	23,000	23,000
– later than one year but within five years	23,539	46,539
– later than five years	–	–
Total	46,539	69,539
Future finance costs	(3,284)	(6,439)
Lease liability	43,255	63,100
Analysed as follows:		
Current portion	20,838	19,845
Long term portion	22,417	43,255
Total lease liability	43,255	63,100

The entity holds an option, exercisable on 31 December 2017, to renew the lease for a further five-year period. Lease payments in the renewal period total €1. The entity intends to exercise the renewal option.

The entity leases the excess machine capacity to an independent third party under an operating lease in return for €4,000 per year for the three-year period 2017–2019.

Contingent rents are incurred when the leased machine produces in excess of 500,000 units in a year. For each unit produced in excess of 500,000 units, contingent rent of €1 is incurred.

Workings – Calculation of Finance charge

		5%		Paid	
1.01.2015	€100,000	€5,000	€105,000	€23,000	€82,000
1.01.2016	82,000	4,100	86,100	23,000	63,100
1.01.2017	63,100	3,155	66,255	23,000	43,255
1.01.2018	43,255	2,162	45,417	23,000	22,417
1.01.2019	22,417	1,122	23,539	23,539	

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Accounting for Operating leases in a lessees financial statements

Both SSAP 21 and FRS 102 require operating lease rental payments to be effectively written off immediately to profit as operating expenses in a lessee's books. It is effectively cash accounting except that outstanding rentals due must also be accrued.

One major difference, however, between SSAP 21 and the FRS is in the disclosure requirements. Under the FRS entities must now disclose the total amount of non-cancellable operating lease rentals due right to the end of the contract split between the amounts due within one year, between two and five years and over five years. In SSAP 21 disclosure is only required of the payments committed to be made during the next year, analysed into those where the commitment expires within one year, between two and five years, in over 5 years etc .

Sale and leaseback operations

FRS 102, as well as covering lessor accounting, provides guidance on how to account for sale and leaseback operations. If a sale and leaseback transaction results in a finance lease, the seller-lessee must not recognise any excess of sales proceeds over the carrying amount as income. Instead, it must defer such excess and amortise it over the lease term.

Example 2

On 1 January 2015 an entity sells a machine with a carrying amount of €90,000 to an independent third party for €120,000 (the fair value of the machine). As part of the arrangement the seller enters into a three-year finance lease arrangement to lease the same machine back from the buyer.

In accordance with the lease €44,066 is payable in arrears on 31 December of each year of the lease term.

On 31 January 2015 the remaining economic life of the machine was estimated as three years with nil residual value.

The interest rate implicit in the lease is 5% per year.

Finance lease obligation amortisation table:

Year	*Discount factor*	*Payment*	*Present value of payment*
2015	1.050	(44,066)	41,967
2016	1.103	(44,066)	39,968
2017	1.158	(44,066)	38,065
Total			**120,000**

The seller-lessee makes the following accounting entries relating to the sale and finance leaseback transaction in the year ended 31 December 20X1:

1 January 20X1

Dr	Cash	€120,000	
Cr	Property, plant and equipment		€90,000
Cr	Deferred income		€30,000

To recognise the sale of the machine.

Dr	Property, plant and equipment	€120,000	
Cr	Lease liability		€120,000

To recognise the finance leaseback of a machine.

31 December 20X1

Dr	Profit or loss—depreciation expense (unless recognised as part of the cost of an asset)	€40,000	
Cr	Property, plant and equipment		€40,000

To recognise depreciation on the leased asset—calculation €120,000 ÷ 3 years.

Dr	Deferred income	€10,000	
Cr	Profit or loss		€10,000

To recognise the amortisation of the deferred income on a straight-line basis over the lease term.

Dr	Profit or loss—finance cost	€6,000	
Cr	Lease liability		€6,000

To recognise finance cost for the period—calculation: €120,000 × 5%.

Dr	Lease liability	€44,066	
Cr	Cash		€44,066

To recognise payment of the lease obligation

If a sale and leaseback transaction results in an operating lease, and the transaction is established at fair value, the seller-lessee must recognise any profit or loss immediately.

If the sale price, however, is below fair value, the seller-lessee should recognise any profit or loss immediately unless the loss is compensated for by future lease payments at below market price. In that case the seller-lessee must defer and amortise such loss in proportion to the lease payments over the period for which the asset is expected to be used.

If the sale price is above fair value, the seller-lessee instead must defer the excess over fair value and amortise it over the period for which the asset is expected to be used.

Conclusion

Reporting entities implementing FRS 102 should not find leasing a particular problem with the only major change being the increased disclosure for both operating and finance leases as well as disclosing total commitments under operating leases. However, the International Accounting Standards Board (IASB) are in the process of trying to implement a new standard on leasing which effectively abolishes the operating lease and will force all leases (apart from those under 12 months duration) onto the balance sheet. In three years' time when FRS 102 is revised that same rule will undoubtedly also be implemented into FRS 102 and this will have a major impact on banking covenants and gearing ratios.