technical factsheet 183

Leases

CONTENTS

1. INTRODUCTION

The purpose of this helpsheet is to provide guidance on the disclosure of accounting for leases within statutory financial statements. This helpsheet will consider the provisions within the Companies Act 2006 and the accounting and disclosure requirements within the related accounting regulations, SSAP 21 Accounting for leases and hire purchase contracts, Financial Reporting Standard for Smaller Entities 2008 (FRSSE 2008), FRSSE 2015 and Financial Reporting Standard 102 (FRS 102) The Financial Reporting Standard Applicable in the UK and Republic of Ireland. We will also consider the contents of the Statement of Recommended Practice (SORP) Accounting issues in the asset finance and leasing industry that provides specific guidance on the application of the standards for lessors.

Please note that the SORP applies under UK Generally Accepted Accounting Principles (GAAP) and is unlikely to be reissued when the new provisions come into force in 2015.

This helpsheet will not address the specific requirements of IAS 17.

2. LEGISLATIVE REQUIREMENTS

The accounting provisions are contained within two pieces of legislation as there are no specific provisions in respect of leases within the Companies Act 2006.

The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008

These regulations apply to all companies that qualify as small and are preparing accounts under the provisions available for small companies.

Section 55 contains details in respect of the disclosure within creditors, including details of security. Section 57 contains details of the disclosure required in respect of any financial commitments.

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008

These regulations apply to all companies that do not qualify as small or are not preparing accounts under these provisions.

Section 61 contains details in respect of the disclosure within creditors, including details of security, the terms of the payment or repayment and the rate of any interest payable on the debt. Section 63 contains details of the disclosure required in respect of any financial commitments.

Companies Act 2006 and the related provisions are accessible on the legislation website:
http://www.legislation.gov.uk/

Disclosure issues under the legislation
Both regulations require disclosure of the amount of any debts included under 'creditors' which are payable or repayable otherwise than by instalments and fall due for payment or repayment after the end of the period of five years beginning with the day next following the end of the financial year, and in the case of any debts so included which are payable or repayable by instalments, the amount of any instalments which fall due for payment after the end of that period.

Both regulations require disclosure of the aggregate amount of any debts included under each item in respect of which any security has been given by the company. Also both regulations require disclosure of particulars of any other financial commitments that have not been provided for, and are relevant to assessing the company's state of affairs. This would be relevant in respect of operating leases.

Specific disclosure issues for large and medium-sized companies
For companies not applying the small company regime it is also necessary to disclose the following information: the terms of payment or repayment and the rate of any interest payable on the debt. However, if the number of debts is such that, in the opinion of the directors, compliance with this requirement would result in a statement of excessive length, it is sufficient to give a general indication of the terms of payment or repayment and the rates of any interest payable on the debts.

For companies not applying the small company regime it is also necessary to disclose an indication of the nature of the securities so given. Section 61(4), Part 3, Schedule of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 states:

'In respect of each item shown under "creditors" in the company's balance sheet there must be stated-
- *(a) the aggregate amount of any debts included under that item in respect of which any security has been given by the company, and*
- *(b) an indication of the nature of the securities so given.'*

Section 63(1) Part 3, Schedule of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 goes on to state: ***'Particulars must be given of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secure.'***

3. ACCOUNTING STANDARDS

The relevant accounting provisions are contained within four standards and one SORP:
- FRSSE (2008) – contains the disclosure relevant to companies that qualify for the small company regime. This will be replaced by FRSSE 2015 for accounting periods commencing on or after 1 January 2015. There are no changes in the accounting requirements proposed by this update.
- SSAP 21 Accounting for leases and hire purchase contracts – applies to all other entities.
- FRS 5 – Reporting the substance of transactions.
- FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland – this standard applies for all entities adopting UK GAAP for accounting periods commencing on or after 1 January 2015 where the FRSSE has not been used.

Definitions
SSAP 21 defines a lease as follows: *'A lease is a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. The term "lease" as used in this statement also applies to other arrangements in which one party retains ownership of an asset but conveys the right to the use of the asset to another party for an agreed period of time in return for specified payments.'*

The standard defines two different types of leases; a finance lease and an operating lease, where a finance lease is: *'A lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset. The present value should be calculated by using the interest rate implicit in the lease. If the fair value of the asset is not* *determinable, an estimate thereof should be used.'* An operating lease is then defined as any lease that is not a finance lease.

The standard does allow a rebuttal of the above definition to exclude or include items as finance leases in exceptional circumstances.

The SSAP provides that hire purchase contracts will usually be treated as finance leases; this definition is broadly in line with FRSSE 2008 and then FRSSE 2015.

FRS 5 seeks to ensure that entities consider the substance of transactions and not just the legal form. This is not inconsistent with SSAP 21 as within this standard we capitalise assets in an entity before legal title has passed to reflect the substance of the arrangement. The standard refers to SSAP 21 and stipulates that the treatment required is consistent, however it may be necessary to refer to the standard if you are dealing with a more complex sale and leaseback transaction or where it is a PFI contract where there is a contract to provide services that requires the provision of a specific asset (usually a part of public/private contracts). In the application material it stipulates that when determining which accounting standard will apply you need to consider the nature of the transaction and apply the standard that contains the most specific guidance on the area, hence for a standalone lease SSAP will usually apply and for a lease that forms part of a more complex transaction you should refer to FRS 5.

FRS 102 also refers to finance and operating leases. It states: *'A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.'*

On determining whether a lease should be treated as a finance lease or operating lease, the standard says that the principle of substance over form should be applied.

The standard goes on to provide examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease as follows:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price that is expected to be suf ciently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications;
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (eg in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Accounting

This section will look at the current regime under SSAP 21 and give an overview of the effect of FRS 102.

The standards provide specific guidance on the accounting treatments for the different types of lease.

SSAP 21 requires for finance leases that: *'A finance lease should be recorded in the balance sheet of a lessee as an asset and as an obligation to pay future rentals. At the inception of the lease the sum to be recorded both as an asset and as a liability should be the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease.'*

Rentals payable should be apportioned between the finance charge and a reduction of the outstanding obligation for future amounts payable. The total finance charge under a finance lease should be allocated to accounting periods during the lease term so as to produce a constant periodic rate of charge on the remaining balance of the obligation for each accounting period, or a reasonable approximation thereto.

This can be calculated using for example the sum of the digits method to ensure that the interest is charged each year at an appropriate rate. In effect this means that at the beginning of the lease term the monthly payments were largely interest and by the end of the lease term a larger proportion of the payment is capital as the balance outstanding decreases and the interest on the same is less.

An asset leased under a finance lease should be depreciated over the shorter of the lease term and its useful life. However, in the case of a hire purchase contract that has the characteristics of a finance lease, the asset should be depreciated over its useful life.

The rental under an operating lease should be charged on a straight-line basis over the lease term, even if the payments are not made on such a basis, unless another systematic and rational basis is more appropriate. Hence where there are rent-free periods etc, the benefits of these should be spread across the lease term.

In the case of a lessor SSAP 21 requires that the amount due from the lessee under a finance lease should be recorded in the balance sheet of a lessor as a debtor at the amount of the net investment in the lease after making provisions for items such as bad and doubtful rentals receivable.

An asset held for use in operating leases by a lessor should be recorded as a fixed asset and depreciated over its useful life. Rental income from an operating lease, excluding charges for services such as insurance and maintenance, should be recognised on a straight-line basis over the period of the lease, even if the payments are not made on such a basis, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable. Where the lessor has incurred costs setting up the lease then these can be spread systematically over the lease.

The accounting requirements are consistent across all of the relevant standards except that under FRSSE the interest on a finance lease can be allocated on a straight-line basis.

The disclosure guidance below is split between disclosure required by a lessee, ie someone leasing the asset and the lessor, ie the person giving the lease.

Where an entity enters in to a sale and leaseback arrangement if the substance of the transaction is in effect a secured loan then the seller would continue to recognise the asset and record the proceeds of the sale as a liability. Interest would be accrued. The accounting policy would need to disclose the nature of the arrangement and where the asset and liability had been recorded.

When considering the accounting and obligations the lease provisions should be considered. Where there are terms in the lease that could result in an additional liability for the entity then consideration should be made of whether additional disclosure is required. This could be for example within an operating lease for a property where there are provisions for remedial work at the end of the contract term. Another example would be in a contract hire agreement for a car where there is an additional sum payable at the end of the contract where a mileage level has been exceeded.

Disclosure by lessees

The following should be disclosed:

- The accounting policies for finance leases and operating leases where applicable.
- The gross amounts of assets which are held under finance leases together with the related accumulated depreciation by each major class of asset.
- The total depreciation allocated for the period in respect of assets held under finance leases by each major class of asset.
- Where the amounts above have been included in the accounts with the owned assets in their respective categories, the net amount of assets held under finance leases included in the overall total should be disclosed with the depreciation on those assets charged in the period.
- The amount outstanding in respect of finance lease liabilities should be disclosed separately on the face of the balance sheet or within the creditors notes in the notes to the accounts.

- The net obligations under finance leases should be analysed between amounts payable in the next year, amounts payable in the second to fifth years inclusive from the balance sheet date, and the aggregate amounts payable thereafter.
- The aggregate of the finance charge included in respect of finance leases.
- Details of the amount of any commitments existing at the balance sheet date in respect of finance leases which have been entered into but whose inception occurs after the year end.
- The total of operating lease rentals charged as an expense in the profit and loss account analysed between amounts payable in respect of hire of plant and machinery and in respect of other operating leases.
- For operating leases, the lessee should disclose the payments which he is committed to make during the next year, analysed between those in which the commitment expires within that year, in the second to fifth years inclusive and over five years from the balance sheet date, showing separately the commitments in respect of leases of land and buildings and other operating leases.

Disclosure by lessors
The following should be disclosed:

- The accounting policy in respect of the finance leases and operating leases, including the policy for accounting for finance lease income.
- The net investment in finance leases and hire purchase contracts at each balance sheet date.
- The gross amounts of assets held for use in operating leases, and the related accumulated depreciation charges.
- The aggregate rentals receivable in respect of an accounting period in relation to finance leases and operating leases.
- The cost of assets acquired, whether by purchase or finance lease, for the purpose of letting under finance leases.

FRS 102 overview
The provisions within the standard are more specific in terms of operating leases. Where there are lease incentives or guaranteed uplifts in rental etc. then these should be spread over the term of the lease. For illustrative purposes, for example if an entity entered in to an operating lease for a property for a five-year period at an initial rent of £100,000 per annum rising to £120,000 after two years and with a six-month rent-free period then when looking at the charge in the accounts you would calculate the amount payable over the five-year term:

Year one	£50,000 (six months rent free)
Year two	£100,000
Year three	£120.000
Year four	£120.000
Year five	£120.000
Total payments	£510,000

The annual charge would be £102,000 in the accounts and not the amounts outlined above.

This is a simple example and does not take into account other factors, £102,000 is calculated on a simple straight-line basis by dividing £510,000 by the five-year period.

In addition to the disclosure above FRS 102 requires the following disclosures to be made:

- In respect of finance leases a general description of the lessee's signi□cant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.
- In respect of finance leases held as a lessor:
    - a reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period. In addition, a lessor shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for amounts receivable within one year, between two to five years and after more than five years;
    - unearned finance income;

- o the unguaranteed residual values accruing to the benefit of the lessor;
  - o the accumulated allowance for uncollectible minimum lease payments receivable;
  - o contingent rents recognised as income in the period; and
  - o a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.
- In respect of operating leases held as a lessor:
  - o the future minimum lease payments under non-cancellable operating leases for amounts receivable within one year, between two to five years and after more than five years;
  - o total contingent rents recognised as income; and
  - o a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, and restrictions imposed by lease arrangements.

4. EXAMPLES

The following are examples of the lease disclosures required in a set of statutory accounts. The examples of the disclosure are consistent in each standard although some of the amounts included will vary as set out within the accounting explanations above.

Hire purchase and finance lease agreements

Assets held under hire purchase agreements are capitalised and disclosed under tangible fixed assets at their fair value. The capital element of the future payments is treated as a liability and the interest is charged to the profit and loss account on a straight-line basis.

Operating lease agreements

Rentals applicable to operating leases where substantially all of the benefits and risks of ownership remain with the lessor are charged against profits on a straight-line basis over the period of the lease.

Operating profit

Operating profit is stated after charging/(crediting):

	20XX	20YY
	£	£
Amortisation	6,853	3,000
Depreciation of owned fixed assets	12,716	12,020
Depreciation of assets held under hire purchase and finance lease agreements	965	1,130
Profit on disposal of fixed assets	(325)	(125)
Operating lease payments in respect of land and buildings	66,397	66,397
Exchange gains on foreign currency purchases	(1,345)	(2,431)
Exceptional item	(18,275)	-

Interest payable and similar charges

	20XX	20YY
	£	£
Interest on hire purchase and finance leases agreements	175	105
Dividend paid on 6% redeemable preference shares	300	300
	475	405

Tangible fixed assets note extract

Hire purchase agreements

Included within the net book value of £136,589 is £9,750 (2008 – £11,300) relating to assets held under hire purchase agreements.

Finance lease commitments

	20XX	20YY
	£	£
Contracted but not provided for in the financial statements	1,875	2,500

Creditors: Amounts falling due within one year

	20XX	20YY
	£	£
Bank loans and overdrafts	31,003	26,724
Trade creditors	9,107	9,285
Other taxation and social security	6,429	5,504
Hire purchase and finance lease agreements	2,750	2,750
Other creditors	923	975
Accruals and deferred income	2,400	3,300
	52,612	48,538

The following liabilities disclosed under creditors falling due within one year are secured by the company:

	20XX	20YY
	£	£
Bank loans and overdrafts	31,003	26,724
Hire purchase and finance lease agreements	2,750	2,750

Creditors: Amounts falling due after more than one year

	20XX	20YY
	£	£
Bank loans and overdrafts	3,500	5,500
Hire purchase and finance lease agreements	-	2,460
6% redeemable preference shares	5,000	5,000
	8,500	12,960

None of the amounts due after more than one year are due after more than five years.

The following disclosed under creditors falling due after more than one year are secured by the company:

	20XX	20YY
	£	£
Bank loans and overdrafts	3,500	5,500
Hire purchase and finance lease agreements	-	2,460

The bank has a floating charge over the company's assets to secure the bank loan. The loans in respect of the hire purchase and finance lease agreements are secured against the assets to which they relate.
(NB this sentence is not required for companies adopting the FRSSE.)

Operating lease commitments
At 31 August 20XX the company had annual commitments under non-cancellable operating leases:

	Land and buildings	
	20XX	20YY
	£	£
Operating leases which expire:		
Within one year	66,397	66,397
Within two to five years	265,588	265,588
	331,985	331,985

5. CHECKLIST

Issue	FRS 8	FRSSE 2008	FRS 102	FRSSE 2015	Comment/reference
As lessee					
Identify all finance leases entered in to as a lessee as defined by the accounting standards. For SSAP 21 and FRSSE 2008 and 2015 this includes anyone satisfying the following conditions: *'A lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset. The present value should be calculated by using the interest rate implicit in the lease. If the fair value of the asset is not determinable, an estimate thereof should be used.'* An operating lease is then defined as any lease that is not a finance lease.					
Identify all finance leases entered in to as a lessee as defined by the accounting standards. For FRS 102 this includes anyone satisfying the following conditions: *'A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.'* The following issues should be considered when determining whether it is a finance or an operating lease: For finance leases consider whether any of the following apply: • the lease transfers ownership of the asset to the lessee by the end of the lease term; • the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised; • the lease term is for the major part of the economic life of the asset even if title is not transferred; • at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; • the leased assets are of such a specialised nature that only the lessee can use them without major modifications; • if the lessee can cancel the lease, the lessor's losses associated with the cancellation are					

borne by the lessee; • gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (eg in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and • the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.					
The accounting policies for finance leases and operating leases where applicable should be ascertained and disclosed in accordance with the requirements above disclosure under SSAP 21, FRSSE 2008, FRSSE 2015 and FRS 102.					
Ascertain and disclose: • The gross amounts of assets which are held under finance leases together with the related accumulated depreciation by each major class of asset. • The total depreciation allocated for the period in respect of assets held under finance leases by each major class of asset. Where the amounts above have been included in the accounts with the owned assets in their respective categories, the net amount of assets held under finance leases included in the overall total should be disclosed, along with the depreciation on those assets charged in the period.					
Ascertain and disclose the amount outstanding in respect of finance lease liabilities on the face of the balance sheet or within the creditors notes in the notes to the accounts.					
The net obligations under finance leases should be analysed between amounts payable in the next year, amounts payable in the second to fifth years inclusive from the balance sheet date, and the aggregate amounts payable thereafter.					
Ascertain and disclose the aggregate of the finance charge included in respect of finance leases.					
Ascertain and disclose details of the amount of any commitments existing at the balance sheet date in respect of finance leases which have been entered into but whose inception occurs after the year end.					
In respect of finance leases ascertain and disclose a general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.					
Ascertain and disclose the total of operating lease rentals charged as an expense in the profit and loss account analysed between amounts payable in respect of hire of plant and machinery and in respect of other operating leases.					

For operating leases, ascertain and disclose the payments which he is committed to make during the next year, analysed between those in which the commitment expires within that year, in the second to fifth years inclusive and over five years from the balance sheet date, showing separately the commitments in respect of leases of land and buildings and other operating leases.					
As lessor:					
Ascertain and disclose the accounting policy in respect of the finance leases and operating leases, including the policy for accounting for finance lease income.					
Ascertain and disclose the net investment in finance leases and hire purchase contracts at each balance sheet date.					
Ascertain and disclose the gross amounts of assets held for use in operating leases, and the related accumulated depreciation charges.					
Ascertain and disclose the aggregate rentals receivable in respect of an accounting period in relation to finance leases and operating leases.					
Ascertain and disclose the cost of assets acquired, whether by purchase or finance lease, for the purpose of letting under finance leases.					
In respect of finance leases held as a lessor ascertain/prepare and disclose: • a reconciliation between the gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period. In addition, a lessor shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for amounts receivable within one year, between two to five years and after more than five years; • unearned finance income; • the unguaranteed residual values accruing to the benefit of the lessor; • the accumulated allowance for uncollectible minimum lease payments receivable; • contingent rents recognised as income in the period; and • a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.					
In respect of operating leases held as a lessor ascertain/prepare and disclose: • the future minimum lease payments under non-cancellable operating leases for amounts					

receivable within one year, between two to five years and after more than five years; • total contingent rents recognised as income; and • a general description of the lessor's significant leasing arrangements, including, for example, information about contingent rent, renewal or purchase options and escalation clauses, and restrictions imposed by lease arrangements.					

6. SOURCES OF INFORMATION

Legislation
The legislation can be accessed at the following website:
www.legislation.co.uk

The following legislation should be referred to when required:
- Companies Act 2006
- The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008
- The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008

Accounting standards
The relevant standards can be accessed on the Financial Reporting Council website at the following link:
http://www.frc.org.uk/Our-Work/Codes-Standards.aspx

The following standards should be referred to when required:
- SSAP 21 – Accounting for leases and hire purchase contracts.
- FRSSE (effective April 2008) – Financial Reporting Standard for Smaller Entities.

- FRS 102 – The Financial Reporting Standard Applicable in the UK and Republic of Ireland.
- FRSSE (effective April 2015) – Financial Reporting Standard for Smaller Entities.

Statements of recommended practice
The relevant SORP in respect of the asset finance and leasing industry can be found at the following link
http://www.fla.org.uk/filegrab/StatementofRecommendedAccountingPractice-SORP1.pdf?ref=508