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FRS 102 Leases Section 20

Practical guide for businesses

FRS 102 Leases – what's changing and what it means for your business

FRS 102 is overhauling lease accounting. Lessees will move to a single on balance sheet model, removing the operating vs finance lease split. From 1 January 2026 (early adoption allowed), most leases will require:

- A right of use (ROU) asset
- A lease liability

This increases balance sheet assets, debt, and shifts costs from rent to depreciation and interest, without changing cash flows.

- Impact - net debt, EBITDA, operating profit, gearing and interest cover will all be affected

Exemptions remain for short term/low value leases. The aim is greater transparency.

Existing finance leases prior to the new rules being adopted are unchanged.

Lessor accounting is also largely unchanged.

Why it matters

- **Higher reported debt** – impacts gearing and solvency
- **Covenants** – ratios may shift, affecting lenders
- **Profit changes** – EBITDA up; operating profile altered
- **More transparency** – commitments now on balance sheet
- **More complexity** – new systems, data, judgements
- **Communication needed** – results change, cash doesn't
- **Audit requirement** – changes to gross assets may change company size and trigger an audit

Practical exemptions

There are two exemptions available which allows leases to avoid balance sheet treatment and be expensed on a straight-line basis instead:

1. **Short term leases**
   - A lease with a term of 12 months or less at commencement or transition
   - Must not include a purchase option

2. **Low-value asset leases**
   - Not defined by a strict threshold but assessed based on the nature of the underlying asset

Low value	Not low value
Computers, laptops, mobiles	Vehicles
Small items of furniture	Production line equipment
Basic security equipment	Buildings

Where a short-term or low value exemption is applied, any associated financial commitment may still require disclosure.

Old vs new lease accounting side-by-side

Old FRS 102 treatment	New FRS 102 treatment	Impact
Leases split into operating and finance; operating leases kept off balance sheet with no recognised asset or liability	Many leases are recognised with a ROU asset and a corresponding lease liability	• Assets and liabilities increase • Potential impact on company size and audit requirement • Higher debt leads to increase in gearing
Operating lease payments were recorded as a single straight line rental expense within operating costs	Rent is replaced by depreciation of the ROU asset and interest on the lease liability, with payments reducing the liability; expenses are front loaded but unchanged across the life of the lease	• Lease costs shift from rent to depreciation and interest • Lease expense becomes front loaded • EBITDA increases • Operating profit improves • Finance costs increase • Interest cover weakens • Return on assets falls
Lease payments sit within operating cashflows on cashflow report	Lease payments are split between principal and interest, with principal in financing cash flows and interest classified as operating or financing, depending on accounting policy	• Total cash flows unchanged • Operating cash flow typically increases • Lease principal repayments move to financing cash flow
Operating leases required relatively limited judgement with regards to treatment	Operating leases require more complex judgements around discount rates, lease terms and reassessments	• More judgement required, increasing uncertainty and risk of error • Reduced comparability between leases • Potentially higher audit costs
Future operating lease commitments disclosed separately, not affecting the balance sheet	Lease commitments move from note disclosure to balance sheet recognition as ROU assets and liabilities	• Lease liabilities on face of balance sheet • Greater transparency of obligations

Transition – how the change is introduced

On transition, unless one of the exemptions applies, lessees recognise right of use assets and lease liabilities for leases previously classified as operating leases, measured at the present value of remaining lease payments.

FRS 102 also includes a practical expedient on transition, allowing businesses to use lease liabilities and right of use assets already measured under IFRS 16 for group reporting, where applicable.

Comparative information is not restated. Instead, the cumulative impact of initially applying the new requirements is recognised as an adjustment to opening profit and loss reserves at the date of transition. In many cases this adjustment is limited but differences can arise, for example where right of use assets are immediately impaired on transition, or where IFRS 16 numbers have already been used for group reporting.

FRS 102 Lease Accounting – a five-step guide for lessees

Step 1 – identifying a lease and considering exemptions

Under FRS 102, a contract is considered a lease if it:

- Conveys the right to control use of an identified asset
- Is for a specified period of time
- Involves consideration

If these criteria are not met, it may be a service or other type of contract.

Step 2 – determining the lease term

This is a key element of the calculation and defined as the non-cancellable period of the lease adjusted for options where the entity is reasonably certain to act.

Include	Ignore
Periods covered by extension options that are reasonably certain to be exercised	Periods after a break clause unless the break option is reasonably certain not to be exercised

This assessment should reflect the economic substance of the arrangement and requires judgement.

Step 3 – determining lease payments

Lease agreements can include more than the stated rent and should reflect the economic reality of the arrangement.

Include	Omit
Fixed payments (i.e. unavoidable payments)	Performance or usage based variable payments
Variable payments linked to an index or rate *	Payments for services (non lease components) unless inseparable from the lease **

* Measured using the index or rate at the commencement date, do not estimate future changes. See further explanation in our complex areas section.

** However, there is an option to treat any service element as part of the lease calculation. This can make things simpler and also improve EBITDA further.

The measurement of the lease liability and right of use asset should take account of all relevant lease payments and lease incentives, including rent-free periods.

Step 4 – selecting the discount rate

Where available, the rate implicit in the lease should be used.

This is a discount rate that depends in part on the lessor's direct costs, which you are unlikely to know. Therefore, we expect companies to use their obtainable borrowing rate, being the rate they would expect to pay to borrow funds over a similar term and for a similar amount.

Step 5 – other costs and ongoing considerations

In addition to lease payments, consideration is needed for other costs associated with the lease. These should be considered as part of the initial measurement of the right of use asset, and include:

- Stamp duty
- Legal fees
- Dilapidations or restoration obligations

These amounts should be tracked appropriately, particularly for tax purposes:

- There may be differences between accounting and tax treatment

Sufficient information should be retained to support future tax analysis.

Lease calculation tools

We have a lease calculation template to support the calculation of right of use assets and lease liabilities. This forms part of the wider support we provide in implementing the new lease accounting requirements.

If you would like to find out more or discuss how this could work in practice, please get in touch.

Less common and complex areas

The points below highlight some additional areas that may arise in practice. While they won't apply in every case, they are included to help you identify and address issues that may require further consideration.

Sub leases

If you lease an asset and then lease it onto someone else, you are acting as a lessor in respect of the sub lease. Lessor accounting is largely unchanged from the previous rules and still distinguishes between finance leases and operating leases:

Substantially all risks and rewards of ownership transfer to the lessee (e.g. lease term covers most of the asset's life)

Finance lease

De-recognise ROU asset and recognise a lease receivable for the total present value of the net investment

The lessor retains substantially all risks and rewards of ownership (e.g. lease term covers only part of the asset's life)

Operating lease

Continue recognising the ROU asset and record rental income on a straight-line basis

Sale and leaseback

Where a sale takes place at market value, the transaction is treated as a sale followed by a lease, with a right of use asset recognised for the leaseback.

However, the full gain on disposal is not usually recognised immediately. Instead, part of the asset is retained through the right of use asset, meaning only a partial gain is recognised upfront.

Where the sale and leaseback is not at market value, adjustments are required so that the transaction is measured at fair value:

- Below market terms are treated as a prepayment of lease payments
- Above market terms are treated as additional financing

As a result, the accounting can vary depending on the terms of the transaction and the judgements applied.

Lease modifications

Lease modifications - a change in or addition to the terms of a lease - are accounted for as either:

A separate lease, where both the following points apply:

- There is an increase in scope (e.g. additional space or assets)
- The consideration reflects that increase (i.e. priced at or near standalone value)

Or a recalculation of the existing lease, for example:

- The change does not meet the criteria for a separate lease:
    - Reduction in scope
    - Change in lease term
    - Renegotiation of lease payments

In these circumstances, the lease payments and discount rate are used to recalculate the lease liability and ROU asset at the modification date. By default, a new discount rate should be calculated, but there are exceptions to this if:

- The lease modification is insignificant
- The scope decreased
- The lease payments decrease and scope does not change

Where there is a reduction in scope, the ROU asset is reduced, with any excess recognised in profit or loss. When making decisions regarding discount rates, take care and document your decisions.

Leases with payments linked to an index or rate

Where lease payments are linked to an index or rate, for example the Consumer Prices Index (CPI), the lease liability is remeasured when the change in the index or rate affects future lease payments. At that date, the lease liability is recalculated using the revised lease payments based on the latest published index or rate and the remaining lease term. The revised cash flows are discounted using the original discount rate.

The resulting adjustment is recognised as a change to the lease liability, with a corresponding change to the right of use asset.

Leases within a group

At an entity level, intercompany leases are accounted for in the same way as third-party leases where conducted on an arm's length basis. These balances are eliminated on consolidation.

Where no formal lease term exists, significant judgement may be required to determine the appropriate lease term. Consideration should be given to the nature of the arrangement, how easily either party could bring it to an end, and the period over which the asset is expected to be used.

Example 1
A subsidiary occupies a specialist building owned by its parent company. Relocating would be difficult, costly and disruptive to the business. It may be reasonable to conclude that the building will be occupied for a long period, resulting in a longer lease term being used for accounting purposes.

Example 2
A subsidiary occupies part of an office building owned by its parent company and could relatively easily relocate elsewhere. It may be reasonable to conclude that a much shorter lease term is appropriate and, if that is twelve months or less, the short-term lease exemption may be available.

These examples illustrate how different facts and circumstances can lead to very different accounting outcomes. The judgements made when determining lease terms can have a significant impact on both the balance sheet and profit and loss account, affecting the value of right of use assets, lease liabilities, depreciation and interest charges recognised. You should think about undocumented or rolling leases carefully and write down why the approach you choose is sensible.

Care should therefore be taken to ensure conclusions are appropriately considered, documented and supported by evidence. Where the correct treatment is unclear, businesses should discuss the position with their accountant or adviser.

Embedded leases

Certain service contracts may contain embedded leases. Where identified, the lease component should be separated and accounted for under FRS 102 lease requirements. Contracts that existed before the transition date do not need to be reassessed for embedded leases, though if you take this exemption you should disclose it.

Dilapidations

Dilapidation provisions still need to be recognised as liabilities. The cost is reflected as an asset over the lease term, even where the lease itself qualifies for an exemption.

There may be differences to this treatment for operating leases that existed on transition.

Tax

Generally, ROU assets do not qualify for capital allowances and therefore there will usually be no deferred tax implications however, there may be a small adjustment required on transition.

The net transitional adjustment in relation to leases are spread for tax over the remaining average lease term.

As the spreading rules create timing differences between the accounting and tax on the recognition of costs, deferred tax will typically arise on transition, unwinding over the spreading period.

Tax relief is now typically obtained on depreciation of the ROU asset and interest on the lease liability, rather than rental expense. Interest on lease liabilities is excluded from corporate interest restriction calculations. Take care to identify any capital items included in initial recognition of the lease.

The rules

The rules on leases can be found in both FRS 102 Section 20 (Leases), and FRS 102 Section 1 paragraphs 1.44 to 1.60 (covering transition).

What to do next

The changes take effect from 1 January 2026, so now is the time to get ahead. Start by pulling together your lease agreements, identifying any short-term or low-value exemptions and assessing the likely impact on your balance sheet, covenants, audit position and tax treatment.

If you would like help working through what this means for your business, please speak to your usual adviser or give us a call. We can help you review your lease data, model the impact and put a practical transition plan in place.