10B: Lease accounting

Introduction

10B.1 The reporting tiers applied for module 10B are as specified in the table below.

Table 10B.1A: Tiered reporting requirements for module

All tiers	The requirements for presentation and disclosure of leases in this module apply to all charities.

10B.2 This module aims to cover the most common types of transactions that charities enter into but for more information, charities should refer to Section 20 Leases of FRS 102.

10B.3 A lease is a contractual agreement between the charity and another party for the use of an asset, usually property, plant or equipment for an agreed lease term in exchange for an agreed series of payments. The party granting the lease is called the lessor and the lessor makes the lease to the party making use of the asset, the lessee.

10B.4. Section 20 of FRS 102 excludes certain lease agreements. These lease agreements are accounted for in accordance with the relevant sections of FRS 102.

10B.5. With the exception of rights held by a lessee under licensing agreements within the scope of Section 18 Intangible Assets other than Goodwill of FRS 102, Section 20 of FRS 102 may be applied to leases of intangible assets but is not required to be.

10B.6. As a lessee there is no longer a distinction between lease agreements that transfer all the risks and rewards of ownership of the asset (finance leases) and lease agreements that do not (operating leases). There is now a single accounting treatment for lessees. Under the new approach the lessee recognises, at the commencement of the lease, an asset and a liability with part of the consideration being paid to the lessor treated as a cost of financing the arrangement. The distinction between finance leases and operating leases is retained for lessors.

10B.7. In recognition of the complexity of lease accounting, Section 20 of FRS 102 provides recognition exemptions for those leases that meet the definition of short-term leases, and leases of low value assets. By opting to take a recognition exemption where available, lessee charities can adopt a simpler accounting approach and treat payments made under short-term leases and leases of low value assets as expenses on a systematic basis over the lease term in a similar way to operating lease arrangements. Lessees may wish to refer directly to the relevant sections of this module at paragraphs 10B.15 to 10B.20.

10B.8. Lease accounting involves a number of terms and familiarity with these is important in order to understand the approach to lease accounting. These terms are:

- Commencement date is the date on which a lessor makes an underlying asset available for use by a lessee.
- Lease liability is the liability recognised at the commencement date by a lessee measured at the present value of the lease payments that are not paid at that date discounted using the interest rate applicable to that lease.
- Right-of-use asset is an asset that represents a lessee's right to use an underlying asset for the lease term.
- Interest rate implicit in the lease is the rate of interest that causes the present value of the lease payments and the unguaranteed residual value, to equal the sum of the fair value of the underlying asset and any indirect costs of the lessor.
- Lease term is 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 that option; and (c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
- Licence agreement is a term used in this SORP to describe an arrangement that allows temporary (a period of 12 months or less), non-exclusive, use of an asset.
- Low value asset is where in a lease arrangement, the underlying asset is of low value on an absolute basis, regardless of whether such leases would be material to the lessee. The value of lease payments has no bearing on the assessment of whether an underlying asset is of low value.
- Social donation lease is defined in this SORP as a lease where the lessor chooses to accept a lower rent for the philanthropic intention of providing a benefit to a public benefit entity.
- Short-term lease is 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.)
- Peppercorn arrangements – in this SORP such arrangements are considered to have the legal form of a lease, but with nil or nominal consideration and are unlikely to meet the FRS 102 definition of a lease but are considered therefore to be a form of non-exchange transaction.

10B.9. An important feature of a lease is that the lessee has a contractual right to control the use of the asset for the term of the lease. This right of control prevents another party from using the asset at the same time except with the lessee's consent.

10B.10. Section 1 of FRS 102 sets out how charities should apply the requirements of Section 20 of FRS 102 for the first time to ease the introduction of the new requirements. Charities must refer to that section of FRS 102 for further detail.

How to use this module

10B.11. This module firstly sets out how to determine whether or not a lease exists. If not, the requirements of Section 20 of FRS 102 do not apply.

10B.12. Where a lease does exist, the charity must then identify the commencement date and lease term. Following that, it can then consider whether the recognition exemptions provided by Section 20 of FRS 102 apply to the arrangements it has. If so, and a decision is made to apply a recognition exemption, further consideration of this module will be limited in respect of those arrangements. The recognition exemptions are explained in paragraphs 10B.15 to 10B.20.

10B.13. Where a lease does exist and a recognition exemption is not applicable or utilised, further consideration of the remainder of the module will then be required. The module goes on to explain the recognition and measurement of leases from the viewpoint of the lessee and then from the viewpoint of a lessor.

10B.14. To assist users of the SORP navigate the sections of this module relevant to them, each section is shown in Table 9.

Table 9: Elements of accounting for leases

Topic	Module paragraph(s)
Recognition exemptions	10B.15 to 10B.20
Lessee and Lessor accounting:	
Identifying a lease agreement	10B.21 – 10B.34
Commencement date and lease term	10B.35 – 10B.40
Separating the components of an agreement	10B.41 – 10B.42
Lessee accounting:	
Lease elements and recognition	10B.43 – 10B.55
Subsequent measurement of the right-of-use asset	10B.56 – 10B.59
Subsequent measurement of the lease liability	10B.60 – 10B.61
Reassessments of a lease after the commencement date	10B.62 - 10B.65

Lease modifications	10B.66 - 10B.67
Arrangements below market rate or for nominal amounts	10B.68 - 10B.73
Nominal or peppercorn arrangements	10B.74 - 10B.77
Social donation leases and non-exchange components of a lease	10B.78 - 10B.84
Lease incentives	10B.85
Provisions for dilapidation or similar costs of making good	10B.86 - 10B.87
Adjustments to lease payments for work carried out by a lessee	10B.88
Sale and leaseback transactions	10B.89
Lease liabilities and the identification of reserves	10B.90
Transition to accruals accounting for leases	10B.91 - 10B.92
Disclosure of lease obligations	10B.93 - 10B.103
Lessor accounting:	
Identifying whether a lease is a finance lease	10B.104 - 10B.110
Accounting for finance leases	10B.111 - 10B.113
Subsequent measurement post recognition	10B.114 - 10B.115
Lease modifications	10B.116 - 10B.117
Operating leases recognition and measurement	10B.118 – 10B.121

Subsequent measurement post recognition	10B.122
Lease modifications	10B.123
Leases as a social investment	10B.124- 10B.126
Sale and leaseback transactions	10B.127
Lessor disclosures	10B.128- 10B.133

Recognition exemptions

10B.15. Before applying lease accounting to the leased assets, the charity's trustees should consider the options offered by Section 20 of FRS 102 and decide whether these apply and whether they wish to exercise an accounting policy choice and take them up.

10B.16. Section 20 of FRS 102 provides exemptions which cover short-term leases and leases involving low-value assets. If an exemption is used, then the lease payments are recognised as an expense on either a straight-line basis over the lease term or on an alternate basis reflecting the pattern of benefit to the charity from using the asset. Application of the recognition exemption for short term leases is to the class of underlying asset - leases where the assets are of similar character, however application of the recognition exemption for low value assets is done by reviewing each lease in turn.

10B.17. Short-term leases are defined as having at the commencement date, a lease term of 12 months or less (FRS 102 Appendix 1 Glossary new definition). However, if there is a purchase option then it cannot be treated as a short-term lease.

10B.18. For an asset to be classed as a low value asset, it cannot be highly dependent on, or highly interrelated with, other assets and it must be capable of use on its own or together with other resources that are readily available to the lessee. This option can be taken even if the item might otherwise be viewed as material to the charity as it is the asset that is considered low value. Section 20 of FRS 102 provides examples of assets that cannot be viewed as low value; these include the lease of cars, vans and lorries, boats, production equipment and land and buildings. This is not an exhaustive list however and judgement must be exercised.

10B.19. Examples of low value assets would typically include personal computers, tablet devices, small items of office furniture and telephones.

10B.20. The disclosure requirements applicable where a charity has applied a recognition exemption are set out in paragraph 10B.100.

Identifying a lease agreement

10B.21. As a practical expedient, a charity may initially wish to consider whether a recognition exemption could apply and if so whether it would wish to apply that exemption to an agreement it has in place for the use of an asset. Where a recognition exemption would not apply or a charity would be unlikely to choose to apply a recognition exemption where it is relevant, the first step is to identify whether an agreement for use of an asset is a lease.

10B.22. A lease is 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 (Appendix 1 Glossary FRS 102 revised definition). The lease contract will normally be documented and communicated in writing. Where there is a lack of clarity in the wording or in the terminology used, the charity may need to exercise judgement to determine substance over form in differentiating a lease agreement from a licence agreement. For a contract to be a lease the identifying features of a lease must be present.

10B.23. The identifying features of a lease contract are:

- A contractual agreement is agreed by the parties for the identified asset.
- The contract may specifically identify the asset or the asset may be implicit when it is made available for use by the lessee
- The agreement gives the lessee the right to control the use of an identified asset. The agreement does this when the lessee has both the right to:
  - direct the use of the identified asset, and
  - obtain substantially all the economic benefits from that use
- There will be a commencement date when the lessee obtains the right of control over the asset from the lessor
- There will be a period of use specified when the lessee has the right of control over the asset. This can be viewed in terms of time or amount of use of an identified asset. For example, where an identified asset is a piece of equipment the amount of use could be the number of units of a product that the asset will be used to produce.
- There are payments due by the lessee to the lessor for the right of control over the asset

10B.24. In some instances it may be appropriate to combine two or more lease contracts that were entered into at or near the same time with the same lessor and treat them as though they were a single contract. Section 20 of FRS 102 requires contracts to be combined where one or more stated criteria are met.

Identified asset

10B.25. For an identified asset to exist, the supplier must not have a substantive right to substitute the asset throughout the period of use. A right to substitute is substantive only where the supplier has both the ability to substitute alternative assets throughout the period of use and would benefit economically from doing so.

10B.26. A portion of an asset can be an identified asset if it is physically distinct, e.g. a floor of a building. A portion of an asset that is not physically distinct can only be an identified asset where it represents substantially all the capacity of the asset and therefore provides the lessee with the right to obtain substantially all of the economic benefits from the use of the asset.

The right to control the use of the asset

10B.27. The right to control is where the lessee has both the right to direct the use of the identified asset and the right to obtain substantially all of the economic benefits from that use throughout the lease term (period of use). These benefits include the ability to generate cash or further the charity's objects.

10B.28. For example, a charity may lease a building or another asset and during the term of the lease the trustees decide on how the asset will be used to further the charity's purposes and direct the activities that are carried out using the asset, including to what extent, if any, it allows others to make use of the asset. If the asset were a building this could be by way of renting out space or subletting space in it to others.

10B.29. A 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.

10B.30. An example of a predetermined purpose would be a machine for drilling wells to source water that is developed for the particular conditions in the locality and which cannot be readily adapted for an alternate use. A custom design would include a new building designed by the charity for its specific needs which the charity leases from the developer.

10B.31. An example of a lease agreement is a vehicle leasing agreement where the lessor grants the charity as lessee, the right to control the use of the vehicle for a term of three years. During the three years, the charity has the right to direct the use of the vehicle and the right to obtain substantially all the economic benefits from that use. At the end of the term the charity has no right to buy the vehicle and must return the vehicle in an agreed condition to the lessor. The lessor assumes control over the vehicle and can then choose whether to lease it out again or dispose of it.

10B.32. Another common example is a charity leasing space in the form of a whole building or one or more floors of a building to carry out some of its charitable activities. The lessor grants the charity the right to use the space in the building for an agreed lease term, say 10 years, at the end of which the charity as lessee must give up its right of control and vacate the building leaving the building or leased space in an agreed condition. During the 10 year term, the charity has the right to direct the use of the building or leased space and the right to obtain substantially all the economic benefits from that use. The lessor regains control over the building or space in the building which it can then lease to a new occupier.

10B.33. Following consideration of the arrangements that the charity has, where the charity determines that a lease does not exist, the requirements of Section 20 of FRS 102 do not apply and the charity should treat the payments made under the arrangement as an expense over an appropriate basis over the term of the arrangement.

10B.34. Where the charity has determined that a lease does exist, the next step is to identify the commencement date and lease term.

Identifying the commencement date and lease term – for lessees and lessors

10B.35. The commencement date is the date on which a lessor makes an asset available for use by the charity and includes any rent-free periods provided to the charity by the lessor.

10B.36. Determining the term of a lease involves exercising judgement where there are options to extend or terminate the lease.

10B.37. At the commencement date, an assessment must be made of what the term of the lease is. The term comprises the non-cancellable period and any additional period which the lessee is reasonably certain to choose to lease the asset.

10B.38. Section 20 of FRS 102 sets out five factors that are expected to be considered when assessing whether an option in a lease is reasonably certain to be exercised which impacts on the term of the lease:

- 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
- conditionality associated with exercising the option

There may also be other relevant factors to consider.

10B.39. Regard should be had for the existence of break clauses and the effect these may have in identifying the non-cancellable lease period. A break clause in a lease contract enables the lessor, the lessee or both to terminate the lease early before the fixed term ends provided the agreed period of notice is given and any conditions met. For example, a charity agrees to lease a building for 25 years with options at the end of years 10 and 20 to terminate the lease. The contract also affords the opportunity for the charity to extend the lease for a further 5 years. The non-cancellable period is therefore the first 10 years. If the charity trustees are reasonably certain that they would not exercise the option to terminate the lease after 10 years but are not reasonably certain that they would not exercise the option to terminate the lease after 20 years, perhaps because they are fundraising to buy their own building, then the term is assessed to be 20 years in total. However, if the charity trustees are reasonably certain that they will remain for the full 25 years and are also reasonably certain that, barring unforeseen events, they will exercise the option to extend the lease, then the term is assessed as 30 years.

10B.40. If only the lessor has the option to terminate the lease, then the term is for the full period set out in the lease agreement. Taking the example of the 25-year lease on the building with an option to extend for 5 years, if the options to terminate the lease after 10 and 20 years can only be exercised by the lessor but not the charity, the non-cancellable period, is assessed as the 25 years specified in the agreement.

Separating the components of an agreement

10B.41. Some agreements may combine the leasing of an asset with other non-lease elements, for example the provision of cleaning, catering or office-related services. In these circumstances the non-lease components of the agreement and their related charges or fees must usually be accounted for separately.

10B.42. The lessee must identify the stand-alone price of the lease and non-lease components using information in the contractual agreement or knowledge of the prices charged by the lessor or similar supplier for the non-lease components. If this information is unavailable, then the price of each component can be estimated. As a practical expedient, Section 20 of FRS 102 permits a lessee to elect, by class of underlying asset, to account for the components as a single lease component.

Accounting for leases as a lessee

10B.43. Once a charity has established that a lease agreement exists, along with its commencement date and lease term and a recognition exemption is not being applied, the charity must proceed to recognise, and therefore measure it.

Lease elements and recognition

10B.44. On initial recognition, the lessee must measure the right-of-use asset at cost and measure the lease liability. The lessee will need to identify the interest element of the lease arrangement. This is necessary because the charity benefits from the use of the asset over the lease term and so the economic benefit gained and the associated cost needs to be attributed to each reporting period over the term of the lease.

10B.45. The calculation is normally done lease by lease but if the charity has a number of leases with similar characteristics, then a portfolio approach can be taken with estimates and assumptions applied at the aggregate portfolio level. These estimates and assumptions must reflect the size and composition of the portfolio.

10B.46. An example of a portfolio might be a charity leasing a fleet of similar sized vehicles for the same period of time to use for delivering aid to beneficiaries. The potential simplifications this offers includes the assessment made of lease terms, the assumptions used in calculating the right of use and associated liability and calculating the ongoing charges for depreciation on the right-of-use asset. However, a portfolio approach can only be taken where the leases have similar characteristics such as having a similar term and being with the same lessor.

10B.47. A charity undertakes to lease an asset to gain a capability, whether it is the capability of occupying a building or space in a building or having the ability to use the capacity of an asset such as equipment or a vehicle to undertake its activities. The right of use represents the economic value that the charity as lessee has in having control over the asset for the term of the lease. Although the charity does not own the asset it enjoys the economic benefits during the lease term just as it would were it to have owned the asset or a similar asset.

10B.48. Measuring the right of use involves calculating the cost. The cost comprises several components:

- the initial measurement of the lease liability assumed upon entering into the lease
- adjustments for any lease payments made at or before commencement date less any lease incentives received. Lease incentives include costs of agreed enhancements or improvements undertaken by the charity as lessee where these costs are assumed by the lessor
- any initial direct costs incurred by the lessee in taking up the lease
- allowance for the expected dilapidation or similar costs of making good in order to return the asset in an agreed condition to the lessor at the end of the lease term (refer to paragraph 20.47(d) of FRS 102)
- an adjustment for any non-exchange transaction component (see paragraphs 10B.78 to 10B.84)

10B.49. The initial lease liability is not measured by simply counting the total amount of money (or consideration) payable to the lessor by the charity over the lease term as an allowance is made for the time value of money.

10B.50. Measuring the lease liability involves calculating the present value of the lease payments due after the commencement date using an interest rate. This is similar to identifying the principal sum advanced when taking out a loan. The charity must identify the rate most appropriate to its circumstances from the permitted options.

10B.51. The default is if the charity can readily determine the interest rate implicit in the lease, then this must be used. The lessor might be willing to advise the charity of the discount rate that it is using in respect of the lease. Where this cannot be readily determined, then the charity can choose the most appropriate of the following permitted options:

- the charity’s incremental borrowing rate which is defined as 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 (Appendix 1

Glossary FRS 102 revised definition). (A charity already borrowing money for another purpose may be able to ask their bank for this information)
- the charity's obtainable borrowing rate which is the rate of interest the charity would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of the lease payments to be included in the measurement of the lease liability (Appendix 1 Glossary FRS 102 new definition)

10B.52. Where a charity is unable to readily determine either the interest rate implicit in the lease, or the charity's incremental or obtainable borrowing rate, the charity is required to use the rate of interest that it could otherwise obtain on deposits held with financial institutions. This might be the option most suitable for charities that never or seldom borrow money.

10B.53. Measuring the finance component of the lease payments involves identifying the total amount to be paid or expected to be paid after the commencement date over the term of the lease and applying the interest rate to work back to the lower value representing its cost. The value of the lease payments comprises the following payments that are not paid at the commencement date:

- fixed payments less any lease incentives receivable
- variable lease payments that depend on an index or rate (using the index or rate values as at the commencement date)
- amounts, if any, expected to be payable by the lessee under residual value guarantees
- the exercise price, if any, of a purchase option if the lessee is reasonably certain to exercise that option
- anticipated payments of penalties for terminating the lease if the lease term reflects the lessee exercising the option to terminate the lease

10B.54. Payments made at the commencement date or prior to it are part of the cost of the right of use asset, but because these amounts have already been paid they are not part of the lease liability.

10B.55. This SORP requires lease liabilities to be shown as a separate item on the balance sheet. Refer to module 10 for more details.

Subsequent measurement of the right-of-use asset

10B.56. The charity must measure the right-of-use asset using the cost model, except for investment property or if the revaluation model is being used for property, plant and equipment.

10B.57. The cost model involves adjusting the carrying amount of the right-of-use asset by a deduction for accumulated depreciation and impairment losses and, where appropriate, any adjustment for any remeasurement of the lease liability. Depreciation is calculated using the same approach as that specified in SORP module 10 for fixed assets. Similarly, an assessment for impairment is made in accordance with SORP module 12. The economic life of the right-of-use asset is taken from the commencement date to the earlier of the end of its useful life or the end of the lease term. The exception to this is where either at the end of the lease term ownership of asset transfers to the charity or the charity, in calculating the initial cost, has decided it is reasonably certain to exercise the option to purchase it. In this case depreciation is over the underlying asset's useful life.

10B.58. Depreciation charges and impairment losses are accounted for as items of expense.

10B.59. In respect of right-of-use assets held for investment purposes refer to SORP module 10 and for the revaluation model also refer to SORP module 10.

Subsequent measurement of the lease liability

10B.60. The carrying amount of the lease liability is increased by the interest charge for the period and reduced by the lease payments made and, if appropriate, adjusted to reflect modifications to the lease or a change in fixed lease payments due. The interest rate applied is determined at the commencement of the lease except where subsequent modifications to the lease require a new interest rate to be determined. Such modifications include agreed changes to the lease term, or a change in the decision about whether to exercise an option to purchase the asset.

10B.61. The interest charge on a lease liability and any variable lease payments not included in the measurement of the lease liability are accounted for as items of expenditure.

Reassessments of a lease after the commencement date

10B.62. Adjustments must be made to the carrying amounts of the right-of-use asset and related lease liability where changes to the lease affect the lease term and/or lease payments. If this happens there is a reassessment of the carrying amount.

10B.63. The required adjustment made to the lease liability is reflected in an adjustment to the right-of-use asset. When a reassessment of the lease liability is made, the interest rate must be reviewed to reflect the adjusted lease term and the prevailing economic conditions. The reassessment should consider any changes to any residual value guarantee or changes due to a market rental rate review or because of an index being applied to the scheduled payments.

10B.64. For example, if at the commencement date the charity had not been reasonably certain that it would exercise an option to extend the lease but subsequently changed that decision and exercises this option, then this is a variation to the lease term.

10B.65. If at the time of reassessment, the carrying amount of the right-of-use asset is reduced to nil and there is a further reduction in the lease liability, this adjustment is included in the other gains and losses section of the Statement of Financial Activities (SORP module 4).

Lease modifications

10B.66. In some circumstances a change counts as a modification to a lease. Some modifications must be treated as a separate lease. Reference must be made to Section 20 of FRS 102 where this situation arises. This is a change not in the original terms of the lease and it includes a change of scope, change of payments due, adding or terminating the right to use one or more underlying assets or shortening or extending the contractual lease term. A modification must be treated as a separate lease if both of the following apply:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets
- the consideration payable under the lease increases by an amount commensurate with the stand-alone price of the underlying assets included in the increase in scope

10B.67. For lease modifications that are not required to be treated as a separate lease, the charity must identify the effect the lease modification has on the components of the lease and reassess the lease liability and the interest element of the lease arrangement. The charity must remeasure the lease liability by discounting the revised lease payments using a revised discount rate determined at the effective date of the modification unless any additional consideration payable is insignificant, decreases the scope of the lease or reduces the amount of consideration payable.

Arrangements below market rate or for nominal amounts

10B.68. Certain lease arrangements are entered into for amounts that are nominal or below market rate. In some cases, such arrangements may be viewed as not having commercial substance or may not be intended to generate a commercial return to the lessor, but instead are arrangements serving a social purpose. Under these arrangements, the payments due may be:

- at nil value;
- of nominal value; or
- significantly below market rates but greater than a nominal amount

10B.69. The intention of a lessor which is a charity in such an arrangement would be to further its own charitable purpose(s). It may do this by making the asset available to:

- another charity;
- a beneficiary; or
- another party with aligned objects that is facilitating assistance to beneficiaries.

10B.70. In the case of a lessor which is a non-charitable organisation, the intention may be to make the asset available to a charity to use with the aim of furthering the charity’s purposes. The lessor may be a government or public authority seeking to further a social purpose.

10B.71. In either case the payment due by the lessee allows the lessor to retain its underlying right of ownership and/or to maintain influence over the use of the asset through the terms of a lease.

10B.72. A charitable or social purpose of the lessor may lead to restrictive conditions or covenants that govern how the lessee exercises its right of use over the asset. For example, a ban on serving or consuming alcohol on the premises or a restriction that permits the asset only to be used by a specific faith group for a faith related activity. This can result in the payments due under the arrangement being low or for a nominal amount. However, the effect of such restrictions may mean that the payments are actually at market rate. Charities with such arrangements will need to consider whether the payments they make can be reasonably considered to be of nominal value or are actually at market rates as this affects how such arrangements are accounted for.

10B.73 Where the intention of the lessor is unclear or the lease is not granted to further a social or charitable purpose, the charity must have regard to substance over form to determine if the lease is classified as having a non-exchange component. An apparently low lease payment may be indicative of:

- an asset in a poor condition
- an asset offered for a significantly restrictive use

In such situations, the payments due over the lease term fairly reflect the market value of the asset and the lease is unlikely to have a non-exchange component.

Nominal or peppercorn arrangements

10B.74. Typically, leases granted for only a nominal amount are known as peppercorn or nominal consideration arrangements.

10B.75. While these arrangements may have the legal form of a lease, it is unlikely they will meet the definition of a lease under FRS 102 as the payments due are likely to be very small or there may be no payment due. Any nominal payments that are made are treated as an operating expense. Such arrangements are outside the scope of Section 20 of FRS 102.

10B.76. Where such arrangements do not meet the definition of a lease under FRS 102, in addition to accounting for the nominal payments due under such arrangements, charities need to consider the benefit that is being received and how that should be measured and accounted for. Module 6 should be referred to for further information on how to account for donated assets, services and facilities. It may be helpful to consider for instance:

- In the arrangement, is it an asset, facility or service that the charity is benefitting from?
- What use is the charity going to make of the asset, facility or service?
- Would the charity have purchased the asset, facility or service if the nominal arrangement had not been made?

- Has the charity in substance been gifted an asset for ongoing use in the delivery of its charitable activities? This may depend on the remaining useful life and the term of the arrangement. In addition, the absence of a break clause, rent review clause or rent escalator may indicate that the transaction is, in substance, a gift when coupled with other factors.
- Is the asset in the arrangement a heritage asset? SORP Module 18 provides details about how to account for heritage assets.

10B.77. The charity must consider the substance of the arrangement and how to account for it. Consideration of the use of the asset, facility or service and whether the charity would have purchased it if the nominal arrangement had not been entered into will be helpful. For example:

- If the arrangement means that an asset is available to the charity to use to carry out its charitable activities, the charity will need to identify the fair value of that asset and account for a donated asset in line with the treatment described in SORP module 6.
- If the arrangement means that a facility or service is now available to the charity, the value to the charity of the facility or service is used and a donation recognised for that amount. Details about the donation of facilities and services can be found in SORP module 6.

Social donation leases and non-exchange components of a lease

10B.78. Lease arrangements where the payments are below market rate 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 are social donation leases. A charity may enter into a social donation lease either as a lessee or lessor.

10B.79. 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

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

10B.80. Social donation leases, by definition, contain a non-exchange component. 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.

10B.81. 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 .

10B.82. The value of the incoming resources from the non-exchange component is recognised as part of the cost of the right-of-use asset (see paragraph 10B.48) 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 such lease arrangements). Where performance-related conditions do exist, the charity recognises the income when the performance-related conditions are met. Refer to SORP modules 5 and 6 for information about the recognition of income from non-exchange transactions.

10B.83 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 is consequently lower than the initial value of the right-of-use asset.

10B.84. The terms of the arrangement and information that is available to the charity as the lessee will determine the accounting for the arrangement. This can be best illustrated by way of examples based on a common set of facts with some critical variations as follows:

Common facts:

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

Table 9A: Example accounting treatments

	Additional facts	**Accounting treatment**
Example 1	The lessor states that as part of its corporate social responsibility activities, it will give the charity a 50% discount on the office space, so the charity will pay £60,000/year instead. If the arrangement not been available, the charity expected to pay £72,000/year for office space elsewhere.	The information available to the charity indicates there is a non-exchange component in the lease. Where the charity determines that it is a facility it has received under this arrangement, it is the value to the charity of the office space that is important. The non-exchange component is £12,000/year - the difference between the value to the charity and the payment 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. Refer to SORP module 6 for more guidance.
Example 2	The lessor states that as part of its corporate social responsibility activities, it will allow the charity to use the office space for a nominal consideration of £10/year. Had this arrangement not been available, the charity expected to pay £72,000/year for office space elsewhere.	The payments made by the charity are very small so the arrangement does not meet the definition of a lease as there is no substantive consideration being paid. The availability of the facility to the charity is treated as a donation of £71,990 per year – the value to the charity less the consideration paid. This is further explained in SORP module 6.

Lease incentives

10B.85. Lease incentives are payments made by the lessor to the charity as an inducement to enter into the lease or a reimbursement or assumption (taking on) of costs by the lessor which the charity would otherwise have to meet that relate to taking on the lease (Appendix 1 Glossary FRS 102 revised definition). Incentives might include reduced payments for the first few years, rent free periods, or the lessor reimbursing the professional surveyor or legal fees associated incurred by the charity in taking on the lease. The economic effect of incentives is to reduce the consideration paid for the lease which is reflected in the value of the right-of-use asset and in the calculation of the lease liability and discount rate.

Provisions for dilapidation or similar costs of making good

10B.86. At the commencement date the charity must consider whether a provision needs to be recognised for the expected costs of making good the asset so that it is returned in the agreed condition at the termination of the lease (referring to SORP module 10A and Section 21 of FRS 102). Where a provision is required, it must estimate the likely cost and recognise that as a provision which must be presented separately on the balance sheet. The amount of any initial provision made is included in the value of the right-of-use asset.

10B.87. Any provision made is subsequently reviewed at each balance sheet date and any adjustment is treated either as impairment loss or a reversal of impairment as appropriate. Please refer to Module 10A on Provisions, Contingent Liabilities and Contingent Assets for more information.

Other considerations:

Adjustments to lease payments for work carried out by a lessee

10B.88 In certain cases the lessor may adjust the payments due under the lease in recognition of the agreed work to be undertaken by the charity as lessee. For example, a charity may enter into a lease for a dilapidated asset such as a building on the understanding that it would make improvements and/or undertake works to the building to bring it into a better state of repair in exchange for a low rent. A judgement needs to be made as to whether the lease is:

- a peppercorn arrangement because the state of the asset is so poor that it is not commercially viable – the payments made by the lessee are treated in line with paragraph 10B.75;
- an arrangement that does not meet the definition of a lease in FRS 102, perhaps due to a lack of commercial substance meaning the payments made by the lessee are treated in line with paragraphs 10B.33 and 10B.76 to 10B.77;
- a social donation lease made for a social purpose because the lease payments are below those that would have otherwise been demanded for the asset even in its current state – refer to paragraphs 10B.78 to 10B.84 for the accounting treatment: or
- a market lease whereby the lessor is anticipating a higher lease rental for subsequent lease agreements as a result of the agreed works to be undertaken by the charity – the charity should follow the requirements for a lessee set out in paragraphs 10B.35 to 10B.65.

Sale and leaseback transactions

10B.89. Charities involved in sale and leaseback transactions must refer to Section 20 of FRS 102 for the accounting treatment that must be followed.

Lease arrangements and the identification of reserves

10B.90. Charities should consider the implications of lease arrangements on the calculation of reserves and refer to SORP module 1 for more information.

Transition to accruals accounting for leases

10B.91. Section 35 of FRS 102 sets out the transitional arrangements that apply when first adopting FRS 102. For charities, this would occur when preparing accruals accounts for the first time. In respect of leases the lessee must:

- identify the lease arrangements in place at the date of its transition to lease accounting based on the facts and circumstances as at that date rather than the earlier commencement date specified in the lease agreement
- measure the lease liability as the present value of the remaining lease payments with the right-of-use asset measured at an amount equal to the lease liability adjusted for any amount prepaid or accrued for lease payments. This does not apply for investment property
- measure investment property held on a lease at fair value

10B.92. Section 35 of FRS 102 also permits the concessions for short-term leases to be taken if the lease ends within 12 months of the date of transition. Also, hindsight can be used in determining the lease term, for example regarding exercising options under the lease. A portfolio approach can also be taken for similar leases.

Disclosure of lease obligations

10B.93. A charity must provide a general description of its significant leasing arrangements.

10B.94. Where necessary to enable users to understand its significant leasing arrangements, all charities must provide additional qualitative and quantitative information. As a minimum, when relevant, a charity must disclose:

- information about future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities, including variable lease payments, extension options and termination options, residual value guarantees and leases not yet commenced to which the lessee is committed
- information about 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 or where none of these can be readily determined, the rate of interest otherwise obtainable by the charity on deposits held with financial institutions) used in calculating lease liabilities and the proportion of the total lease liability calculated using each of those types of discount rate
- information about sale and leaseback transactions including all the disclosures required by Section 20 of FRS 102

10B.95. Where a charity has any leases classified as social donation leases or peppercorn arrangements, this SORP requires the charity to provide a general description of the lease term, the remaining term if not a perpetual lease, any restrictions or conditions as to the use of the right-of-use asset and the presence of any reversion clauses. In addition, where a charity has incoming resources from a non-exchange transaction as part of a social donation lease, it must fulfil the disclosure requirements set out in paragraph 6.32 of this SORP in respect of those resources and where key judgements have been made by the charity in applying the relevant accounting policies to those resources, the disclosure requirements set out in paragraph 3.54 of this SORP must also be followed.

10B.96. A charity that has either applied the portfolio approach to accounting for leases or for expediency included non-lease components associated with a lease and the lease as a single lease component must disclose taking these accounting treatment options.

10B.97. A charity that has remeasured a lease liability as a result of a lease modification and has used an unchanged discount rate, must disclose:

- that fact
- the carrying amount at the end of the reporting period of lease liabilities which have been remeasured in that manner

10B.98. All charities must disclose the following amounts for the reporting period:

- interest expense on lease liabilities
- the expense relating to short-term leases if applying the relevant recognition exemption (see paragraphs 10B.15 to 10B.20) except for any expense relating to leases with a lease term of one month or less
- the expense relating to leases of low-value assets if applying the relevant recognition exemption (see paragraphs 10B.15 to 10B.20) except for those expenses relating to short-term leases of low value assets
- the expense relating to variable lease payments not included in the measurement of lease liabilities
- income from subleasing right-of-use assets
- total cash outflow for leases
- gains or losses arising from sale and leaseback transactions.

10B.99. All charities must disclose the following amounts for the reporting period for right-of-use assets, by class of underlying asset:

- the gross carrying amount and the accumulated depreciation at the beginning and end of the reporting period
- a reconciliation of the carrying amount at the beginning and end of the reporting period showing separately:
    - additions
    - disposals
    - acquisitions through business combinations
    - revaluations
    - impairment losses recognised or reversed in the Statement of Financial Activities
    - depreciation
    - other changes

This reconciliation need not be presented for prior periods.

10B.100. Where a charity has chosen to apply the recognition exemptions for short-term leases or leases of low-value assets, it must disclose that fact and 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, and for each of the following periods:

- not later than one year
- later than one year and not later than five years
- later than five years

10B.101. For right-of-use assets meeting the definition of investment property, a charity must apply the disclosure requirements in SORP module 10. In that case the disclosure of income from subleasing and the requirements of paragraph 10B.99 above are not required.

10B.102. For right-of-use assets meeting the definition of heritage assets, a charity must apply the disclosure requirements set out in SORP module 18. In that case the disclosure of income from subleasing and the requirements of paragraph 10B.99 above are not required.

10B.103. If a charity measures right-of-use assets classified as property, plant and equipment using the revaluation model then the charity must provide the disclosures required by SORP module 10 for those right-of-use assets.

Accounting for leases as a lessor

10B.104. As a lessor there remains a distinction between an operating lease and finance lease. The lessor must classify the lease to be a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset otherwise it is classified as an operating lease.

Identifying whether a lease is a finance lease

10B.105. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Section 20 of FRS 102 provides examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- the lease transfers ownership of the underlying asset to the lessee by the end of the lease term
- the lessee has the option to purchase the underlying 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 date, that the option will be exercised
- the lease term is for the major part of the economic life of the underlying asset even if title is not transferred
- at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset
- the underlying asset is of such a specialised nature that only the lessee can use it without major modifications

10B.106. Section 20 of FRS 102 also sets out indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease:

- 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 fair value of the residual accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

10B.107. Judgement will need to be exercised based on whether substantially all the risks and rewards incidental to ownership transfer to the lessee. If it is clear from other features that the lease does not do this, the lease is classified as an operating lease. An example of a feature that may indicate the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset is where ownership of the underlying asset transfers to the lessee at the end of the lease term for a variable payment equal to its fair value at that time.

10B.108. If supplying non-lease services as part of a contract that contains a lease then the lessor must account for these separately and allocate the consideration between the lease and non-lease components.

10B.109. Lease classification is made by the charity at the inception date. A charity must review the classification of a lease if it is subsequently modified, however changes in estimates including an asset's economic life or residual value, or changes in circumstances, for example default by the lessee, do not warrant reclassifying the lease (paragraph 20.91 of FRS 102).

10B.110. An intermediate lessor must refer to Section 20 of FRS 102 in regard to sub-leases and their classification as a finance lease or operating lease.

Accounting for finance leases

10B.111. Paragraphs 10B.35 to 10B.40 explain how to identify the commencement date and lease term.

10B.112. At the commencement date the lessor recognises the value of the asset in the balance sheet and presents it as a receivable at an amount equal to the net investment in the lease inclusive of initial direct costs. In substance the lessor has acquired an asset in order to make it available to the lessee to use the asset over its economic life and so it is similar to a loan financing arrangement even though legal title has not been transferred. The figure for the net investment is derived by allowing for the time value of money represented by the interest rate implicit in the lease. Different accounting treatments apply in the case of manufacture or dealer lessors. It is unlikely that charities will undertake the activities of manufacturers or dealers as lessors of assets but where they do, they must refer to Section 20 of FRS 102 for the accounting treatment.

10B.113. The lease payments included in the measurement of the net investment in the lease comprise the payments made by the lessee for the right to use the underlying asset that have not been received at the commencement date. These are:

- fixed payments including payments that although described as variable that are in-substance fixed lease payments, less any lease incentives payable
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date
- 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

- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Subsequent measurement post recognition

10B.114. The lessor charity must apply the payments received from the lessee to reduce both the principal and the unearned finance income (the difference between the gross investment in the lease and the principal sum). The payments from the lessee comprise the element that reduces (pays off) the principal (the net investment in the lease which is the lease receivable debtor) and the interest income (earnings to the lessor). The lessor must recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. The gross investment in the lease, which is defined as the total of the lease payments receivable by the lessor under a finance lease plus any unguaranteed residual value accruing to the lessor is therefore not necessarily equal to the payments from the lessee because of the profit (investment return) to the lessor and any variable lease payments receivable.

10B.115. The charity must review at each balance sheet date whether the financial asset of the lease receivable is impaired. Refer to SORP module 11 for the treatment of an impairment loss. Also, if there has been a reduction in the estimated unguaranteed residual value, the lessor must revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

Lease modifications

10B.116. In some circumstances a lease modification exists and some lease modifications are treated as a separate lease. Reference must be made to Section 20 of FRS 102 where this situation arises. A modification must be treated as a separate lease if both of the following apply:

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

10B.117. For a modification to a finance lease that is not accounted for as a separate lease, a lessor charity must account for the modification as follows:

- if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor charity must:
  - account for the lease modification as a new lease from the effective date of the modification
  - measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification

- otherwise, the lessor charity must refer to the treatment of financial assets in SORP module 11

Operating leases

10B.118. The lessor charity treats the leased asset as property, plant and equipment (refer to SORP module 10) since it will only be leased for part of its economic life leaving the lessor with the ability to make use of the asset. The lessor charity has not transferred to the lessee substantially all the risks and rewards incidental to ownership of an underlying asset. A charity with activities of a manufacturer or dealer lessor must refer to Section 20 of FRS 102 for the accounting treatment of any selling profit on entering into an operating lease.

Recognition and measurement

10B.119. The charity must add any initial direct costs incurred in effecting an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the letting income from the operating lease.

10B.120. The lessor charity must recognise lease payments from operating leases as income on a straight-line basis, unless either:

- another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished
- the lease payments are structured to increase in line with expected general inflation to compensate the charity for the effect of inflation in increasing costs

10B.121. The charity applies a consistent approach to its depreciation policy for depreciable underlying assets subject to operating leases treating them in the same way as its normal depreciation policy for similar assets.

Subsequent measurement post recognition

10B.122. The charity must review assets subject to an operating lease for impairment (refer to SORP module 12).

Lease modifications

10B.123. A charity must 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.

Leases as a social investment

10B.124. 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 of the charity.

The charity retains title to the asset and because it is leasing it as means of furthering its charitable purposes, treats the asset in the same manner as other assets that it owns (refer to SORP module 10 Balance sheet) with appropriate charges for depreciation and an annual review for impairment. This SORP requires income receivable under such arrangements to be treated as an annual rental income.

10B.125. A charity entering into a finance lease at below market rate to a lessee is making a social investment and is in substance offering a concessionary loan to the lessee. Under this SORP, the measurement of the net investment in the lease and recognition of the finance income is the same as a finance lease but this SORP requires the charity to class these as a separate component of its concessionary loans (refer to SORP module 21 Accounting for social investments).

10B.126. 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 to that of any other operating lease. While the lease payments may be significantly below market rates, this is unlikely to be an indicator of impairment of the asset because the asset is performing its intended purpose of providing social or charitable benefit.

Other considerations:

Sale and leaseback transactions

10B.127. Charities involved as lessor in sale and leaseback transactions must refer to Section 20 of FRS 102 for the accounting treatment that must be followed.

Lessor disclosures

10B.128. A charity must disclose a 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.

10B.129. Where a charity grants a lease as a social investment or arrangements with nil or nominal consideration, e.g. peppercorn arrangements, this SORP 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.

10B.130. If necessary to enable users to understand its significant leasing arrangements, a charity must disclose additional qualitative and quantitative information.

10B.131. A charity must disclose the following amounts for the reporting period:

- for finance leases:
  - selling profit or loss
  - finance income on the net investment in the lease

  - income relating to variable lease payments not included in the measurement of the net investment in the lease
- for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate

10B.132. In respect of finance leases a charity must:

- provide a qualitative and quantitative explanation of the significant changes during the reporting period in the carrying amount of the net investment in finance leases
- disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation must identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value. A lessor must disclose the accumulated allowance for uncollectible lease payments receivable

10B.133. In respect of operating leases a charity must:

- for items of property, plant and equipment subject to an operating lease, a lessor must apply the disclosure requirements of SORP module 10. In applying the disclosure requirements in SORP module 10, a lessor must disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases. Accordingly, a lessor must provide the disclosures required by SORP module 10 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor
- a lessor must apply the disclosure requirements as applicable in SORP module 10 for investment property, intangible assets other than goodwill, and for impairment (SORP module 12), heritage assets (SORP module 18) and social investment (SORP module 21) for assets subject to operating leases. A charity must also disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years