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Changes to Lease Accounting under FRS102

Alliotts LLP: IFRS 16 comes to UK GAAP in the upcoming FRS 102 Amendments

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1. Introduction

On 27 March 2024, the Financial Reporting Council (FRC) published the “Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review 2024.” These amendments mark a pivotal update to lease accounting under FRS 102, aligning more closely with IFRS 16, which has been in force since 2019. A key change is the requirement to capitalise most leases on the balance sheet, a shift that will significantly alter how businesses report their financial positions.

Previously, entities with operating leases could treat lease payments as simple expenses recorded in the profit and loss account, but the updated guidance recognises that such leases provide the business with control over and benefits from the underlying asset. This change will enhance transparency by giving investors and stakeholders a clearer view of an entity’s true financial obligations. However, it will also bring challenges in terms of increased administrative burden and the need to adjust existing financial processes.

The amendments will affect a broad spectrum of businesses, particularly those that lease property, vehicles, or other high-value assets. With implementation set for 1 January 2026, entities need to act now to prepare for these sweeping changes.

2. Who Will Be Affected?

These amendments are relevant to all entities that report under FRS 102, the financial reporting standard widely used by UK private companies, partnerships, charities, and some public benefit entities. The changes reflect principles first introduced by IFRS 16, a standard that publicly listed companies have been adhering to since 2019. Listed companies that report under IFRS at the group level may have subsidiaries that prepare accounts and have financial covenants that are prepared under existing FRS 102. This created a disparity between group and subsidiary reporting, which introduced complexities in maintaining compliance across different frameworks.

While the alignment of FRS 102 with IFRS 16 aims to standardise financial reporting across different frameworks, the impact on smaller and mid-sized businesses that have not previously reported under IFRS is likely to be significant.

Businesses that lease high-cost items such as retail stores, office spaces, vehicles, equipment, or aircraft will feel the most significant effects. These Entities will experience changes not only in how their financial statements look but also in how they comply with loan covenants and manage their internal financial systems.

2. Who Will Be Affected?

The scope of the amendments will affect over a million reporting entities in the UK. This includes businesses across diverse industries, from retail to logistics, that may not yet have considered how lease capitalisation will affect their balance sheets and profitability metrics. Preparing for these changes is essential, as failure to adapt could result in covenant breaches, disruptions to financing arrangements, and challenges in meeting stakeholder expectations.

With the effective date of 1 January 2026 approaching, all entities should begin preparations now to ensure compliance, particularly those whose financial performance depends on complex leasing arrangements. Early engagement with your accountants will be crucial to successfully navigate this transition.

3. How Will the New Rules Change Lease Accounting?

Currently, rental payments under operating leases are treated as expenses in profit or loss accounts. From 1 January 2026, entities must capitalise most operating leases by recognising the present value of lease payments as ‘right-of-use’ assets or as part of ‘property, plant, and equipment.’

The corresponding lease liability will be the discounted future lease payments.

Key changes include:

- Depreciation of right-of-use assets over the lease term.
- Replacement of operating lease expenses with a depreciation charge on the asset and a finance charge on the liability.
- Transition date requirements: Lease liabilities will be measured at the present value of remaining lease payments, discounted using the lessee’s incremental borrowing rate or an obtainable borrowing rate.
- Entities already using IFRS 16 for group reporting can use existing carrying amounts under FRS 102 to ensure consistency across reporting frameworks, minimising discrepancies.

Summary of Financial Impacts:

- Assets: Increase due to recognition of right-of-use assets.
- Liabilities: Increase as future lease payments are discounted and capitalised.
- EBITDA and operating profit: Increase, as lease costs will be classified under finance costs instead of operating expenses.

4. Effects on Financial Ratios and Covenant Compliance

Entities leasing high-value assets such as retail stores, offices, vehicles, or aircraft will experience significant shifts in financial metrics due to the new FRS 102 lease accounting rules. Key performance indicators (KPIs) like EBITDA, leverage, and interest cover will be impacted, potentially triggering covenant breaches and affecting business valuations and incentive plans tied to financial performance.

A notable change will be the rise in EBITDA, as lease costs will no longer be recognised as operating expenses. While this may improve perceived profitability, leverage ratios will increase due to the capitalisation of lease liabilities, making entities appear more indebted. This could cause concern among lenders, particularly where debt covenants impose limits on leverage or require minimum EBITDA thresholds.

Additionally, interest cover ratios may weaken, as lease costs will now be split between depreciation and finance charges, reducing the ability to cover interest payments. Entities should review loan agreements to assess the risk of breaching these covenants and explore options such as renegotiating terms or applying ‘frozen GAAP’ provisions to mitigate potential issues.

Another critical consideration is the impact on CapEx-related covenants. Lease capitalisation could inflate reported asset levels, potentially breaching covenants that limit capital expenditure or require specific asset-to-debt ratios. Entities with such covenants should carefully model the new lease accounting effects to ensure compliance.

Beyond debt metrics, the changes may also influence business valuations, as higher EBITDA could alter valuation multiples, while increased debt levels may reduce attractiveness to investors. Bonus schemes and share options linked to financial metrics like EBITDA or net profit should also be reviewed to ensure targets remain achievable under the new framework.

In summary, businesses must act now to remodel financial covenants, engage with lenders, and ensure compliance before the amendments take effect on 1 January 2026. Early preparation will help mitigate risks and safeguard financial stability.

5. How Can Entities Prepare?

Alliotts LLP recommends the following actions to mitigate potential impacts:

1. **Recalculate financial covenants** to align with FRS 102 changes.
2. **Engage lenders early** to discuss covenant adjustments or the use of 'frozen GAAP.'
3. **Implement robust lease data systems** to capture accurate lease information, borrowing rates, and lease terms.
4. **Assess systems and processes now** to ensure readiness by **1 January 2026**.

As IFRS 16 experts, Alliotts LLP is prepared to guide businesses through these complex changes, ensuring a smooth transition and compliance with the revised FRS 102 standards. Reach out to us today to prepare your organisation for the upcoming changes.

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