Helpsheet – Step by step guide to accounting for leases as a lessee
Part 2: accounting for a lease where the payments are at market rent

What do the figures in the charity's accounts mean?

Where a charity, as a lessee, is accounting for a lease that is at market rent, and a recognition exemption is not applied, it will have:

- an asset on its balance sheet that represents the right of use it has over the identified asset in the lease agreement. The cost of the right-of-use asset is a figure that is calculated by including a number of different elements, and
- a liability on its balance sheet representing the present value of the money due to the lessor over the term of the arrangement. The total payments due over the term of the lease are adjusted to reflect the fact that money due in the future is worth less than money paid today. This is called the time value of money.

How to account for a lease

Once the charity has established that its arrangement meets the definition of a lease within FRS 102 (see Part 1 of this helpsheet for more guidance), it can then proceed to understand how to account for it.

This section explains how to find the relevant explanations within module 10B of the SORP for what to do in the first year of recognising a lease arrangement and in subsequent years. Examples to illustrate how to meet the relevant requirements are also provided.

Example 1 explains the first year of recognising a lease arrangement and example 2 explains what to do after initial recognition of a lease arrangement.

In the first year of recognising a lease arrangement:

	Paragraphs of module 10B of the SORP to read
When the charity first recognises the lease arrangement in its accounts, it must measure the right-of-use asset and the lease liability.	10B.44 to 10B.56
A charity must disclose information in the notes to the accounts about its lease arrangements.	10B.94 to 10B.104

Example 1 - steps to take in the first year of recognising a lease arrangement

A charity enters into an agreement on 01/01/X1 to use one floor of a five-storey office building for three years. For the purposes of this example, there are no break clauses or options to extend the period of the lease in the agreement. The other four floors are occupied by the lessor, a commercial business. The charity pays the market rent for this floor of £120,000 per year (paid in arrears).

Step 1 – determine what interest rate to use

To measure the right-of-use asset and the lease liability, the charity needs to use an interest rate.

- If the charity knows the **interest rate implicit in the lease**, then this must be used[1]. In some cases, the lessor may be able to tell the charity the interest rate implicit in the lease.
- Where the interest rate implicit in the lease cannot be readily determined, then the charity can choose either the charity's **incremental borrowing rate** or the charity's **obtainable borrowing rate** for that lease.
- 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 must use the rate of interest that it could otherwise obtain on deposits held with financial institutions. This could be the rate of interest the charity receives on deposit accounts with their bank or if this is not relevant, a general deposit rate of interest with a financial institution.

For the purposes of this example, the charity cannot readily determine the interest rate implicit in the lease, so the charity has a choice between using its incremental borrowing rate or its obtainable borrowing rate for that lease. It chooses to use its obtainable borrowing rate which – taking into account a quote from its bank to borrow £360,000 over a similar term – it determines is 6%.

See Annex 1 for definitions of the rates that are shown in bold within Step 1.

Step 2 - measure the lease liability

The initial measurement of the lease liability involves calculating the present value of the lease payments due after the commencement date using an interest rate.

The table below shows this by setting out the undiscounted and discounted cashflows using the interest rate determined in Step 1. Refer to Annex 2 for more information about calculating discounted cashflows.

[1] Except on initial application of the revised Section 20 following the Periodic Review 2024 amendments – refer to Financial Reporting Council's Factsheet 9 – Initial Application of the Periodic Review 2024 amendments.

Date	Lease payment	Discount factor	Discounted amount
	£		£
31/12/X1	120,000	1.060	113,208
31/12/X2	120,000	1.1236	106,799
31/12/X3	120,000	1.191016	100,754
	360,000		**320,761**

Therefore, the lease liability is initially recognised at £320,761 at the commencement of the lease, and this is one component of the right-of-use asset.

Step 3 - measure the cost of the right-of-use asset

Measuring the right of use involves calculating the cost. The cost comprises several components including the initial measurement of the lease liability, see paragraph 10B.49 of the SORP.

As no lease incentives were offered nor were any payments made at or before the commencement date, and, as a simplifying assumption, the charity did not incur any initial direct costs (see paragraph 10B.49 of the SORP), the cost of the right-of-use asset is the same as the initial measurement of the lease liability. Therefore, the right-of-use asset is also recognised at its cost of £320,761 at the commencement of the lease.

Although not relevant to this example, the cost of the right-of-use asset may include an allowance for dilapidations or similar costs of making good to return the asset in an agreed condition at the end of the lease term. Refer to paragraphs 10B.49, 10B.87 and 10B.88 of the SORP.

After initial recognition of a lease arrangement:

	Paragraphs of module 10B of the SORP to read
After the initial recognition of the lease arrangement, the carrying amounts for the right-of-use asset and the lease liability are adjusted in the charity's accounts as the lease elapses.	10B.57 to 10B.62
A charity must continue to disclose information in the notes to the accounts about its lease arrangements.	10B.94 to 10B.104

In the first year of recognising the lease arrangement in Example 1, the initial measurement of the lease liability at 01/01/X1 is £320,761. The liability reflects the payments due over the term of the lease. Example 2 shows the measurement of the lease liability and the presentation in the accounts after the first year of recognising a lease arrangement.

Example 2 - steps to take after initial recognition of a lease arrangement

Step 1 - subsequent measurement of the right-of-use asset

The initial cost of the right-of-use asset of £320,761 (Step 3, Example 1) would typically be depreciated on a straight-line basis over the three-year lease term.

Presentation and disclosure in the accounts:

A lessee charity must either present the right-of-use assets separately from other assets in the balance sheet or disclose in the notes. If a lessee does not present right-of-use assets separately in the balance sheet, the lessee must:

(i) include right-of-use assets within the same line item (for example plant and equipment) as that within which the corresponding underlying assets would be presented if they were owned; and

(ii) disclose which line items in the balance sheet include those right-of-use assets.

The notes to the accounts must include a reconciliation of the carrying amount of the right–of-use asset at the beginning and end of the reporting period. This could be disclosed as follows:

Leasehold land and buildings	31/12/X2	31/12/X1
	£	£
Cost		
At the beginning of the year	320,761	-
Additions	-	320,761
Disposals	-	-
At the end of the year	**320,761**	**320,761**
Depreciation		
At the beginning of the year	106,920	-
Depreciation charge	106,920	106,920
At the end of the year	**213,840**	**106,920**
Net book value at the beginning of the year	213,841	-
Net book value at the end of the year	106,921	213,841

The depreciation expense must be recognised in the SoFA. For example, for the year ended 31/12/X2, depreciation expense would be £106,920.

Step 2 - subsequent measurement of the lease liability

The interest expense is equal to the interest rate (6%) multiplied by the opening balance of the lease liability for the period because payments are in arrears.

The table below shows how the lease liability reduces to zero over the lease term:

Date	Opening balance	Interest expense	Lease payment	Closing balance
	£	£	£	£
31/12/X1	320,761	19,246	(120,000)	220,007
31/12/X2	220,007	13,200	(120,000)	113,207
31/12/X3	113,207	6,793	(120,000)	0
		39,239	**(360,000)**	

Presentation in the accounts:

The lease liabilities must be presented separately from other liabilities on the balance sheet (see paragraph 10B.56 of the SORP).

Step 3 - other accounting entries

The interest expense must be recognised in the SoFA. For example, for the year ended 31/12/X1, interest expense would be £19,246.

The SORP requires the disclosure of certain information on material individual fund balances. If this is relevant to your leasing transactions, see Module 2, Fund accounting of the SORP.

Using spreadsheets for calculations – reproduced from FRS 102 Factsheet 11[2]

Discounting can be done in spreadsheets using a line-by-line approach for each period or one of the inbuilt formulae. There are generally three such formulae – PV, NPV and XNPV. It should be noted that PV assumes that the periodic cashflows are identical and at the end of a period, NPV allows differing cashflows but only allows them to be at the end of a period, and XNPV allows full flexibility over cashflow amounts and timing. Care will be needed to ensure that appropriate formulae are applied to appropriate inputs.

Other considerations

In the lease arrangement that a charity has, there may be specific terms or situations that also need to be considered. Module 10B of the SORP covers a number of these, as set out in the table below. Examples 3 and 4 below provide an illustration of the first and third items in the table.

[2] © Financial Reporting Council Ltd (FRC). Adapted and reproduced with the kind permission of the FRC. All rights reserved

	Paragraphs of module 10B of the SORP to read
Where the agreement combines a lease with other non-lease elements such as cleaning, see Example 3, below.	10B.42 to 10B.43
Changes to the lease after the commencement date.	10B.63 to 10B.68
Where the charity receives an incentive to enter into the lease arrangement from the lessor, see Example 4 below.	10B.86
Where the charity may incur costs in making good the asset it is leasing at the end of the lease term.	10B.87 to 10B.88
If the charity carries out work on the leased asset and the lessor reduces the payments due by the charity as a result of that work.	10B.89
Where the right-of-use asset is used to carry out the charity's activities, the charity may need to exclude it from unrestricted funds when calculating the charity's free reserves.	Module 1 Trustees' Annual Report of the SORP Appendix 1: Glossary of terms of the SORP
Where a charity enters into a rolling lease, meaning there is no specified term or end date.	10B.41
Variable lease payments that depend on an index or a rate.	10B.54, 10B.64 FRS 102 Factsheet 11, examples 3a, 3b and 3c.

Where a charity is considering how to treat irrecoverable VAT on a lease, FRS 102 and the SORP do not specify an accounting treatment so charities will need to apply judgement and may need to seek professional advice.

Example 3 - where the agreement combines a lease with other non-lease elements such as cleaning

A charity enters into a contract to lease 2 identical floors of an office building, with accompanying cleaning services and insurance coverage for a total consideration of £240,000 (£120,000 per floor). The standalone selling price of leasing a floor of the building is £118,000; the standalone selling price of cleaning services (per floor) is £3,000 and insurance (per floor) is £2,000.

The following table sets out the proportion of the total standalone price that relates to each component, which is then applied to the total contract amount of £240,000 to determine the share of the total contract amount that relates to each component.

	Standalone price	% of standalone price	Share of total contract amount allocated to each component
	£		£
Floor 1	118,000	48%	115,200
Floor 2	118,000	48%	115,200
Non-lease	10,000	4%	9,600
	£246,000		**£240,000**

Lease and non-lease components are accounted for separately unless the lessee applies the practical expedient in paragraph 10B.43 of the SORP, see below.

In the example above, a charity applying the practical expedient would instead elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. In the above example, the charity would instead identify two lease components each with £120,000 consideration allocated.

Example 4 - where the charity receives an incentive to enter into the lease arrangement from the lessor (based on Example 3a, FRS 102 Factsheet 11):

A lessee enters into a five-year property lease on 01/01/X1, with annual lease payments of £20,000 (paid in advance), an initial six-month rent-free period, and a cash lease incentive of £3,000 received at the start of the lease (as opposed to receivable in the future).

The lease payments to be reflected in the calculation of the lease liability are as follows:

Date	Lease payment
	£
01/07/X1	10,000
01/01/X2	20,000
01/01/X3	20,000
01/01/X4	20,000
01/01/X5	20,000

The cash lease incentive of £3,000 is not included in the calculation of the lease liability but is deducted from the cost of the right-of-use asset. The benefit of the cash lease incentive is therefore recognised as reduced depreciation of the right-of-use asset.

Annex 1 – Definitions

Interest rate implicit in the lease (definition from FRS 102) 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 initial direct costs of the lessor.

Lessee's incremental borrowing rate (definition from FRS 102) is 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.

Lessee's obtainable borrowing rate (definition from FRS 102) is the rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of lease payments to be included in the measurement of the lease liability.

Annex 2 - Calculating discounted cashflows

Step 1: Identify the cashflows

In example 1 above, the cashflows are the lease payments of £120,000 for each of the year ends 31/12/X1; 31/12/X2; and 31/12/X3:

Date	Lease payment
	£
31/12/X1	120,000
31/12/X2	120,000
31/12/X3	120,000
	360,000

Step 2: Calculate the discount factor

In example 1 above, the charity cannot readily determine the interest rate implicit in the lease, so it uses its obtainable borrowing rate of 6% instead. A discount factor is needed to convert future cash flows into their present value at 01/01/X1. The following formula can be used to calculate the discount factor: $(1+i)^t$ where i is the discount rate per period as a decimal; and t is the number of time periods to which it applies.

Date	$(1+i)^t$	Discount factor
31/12/X1	$(1+0.06)^1$	1.060
31/12/X2	$(1+0.06)^2$	1.1236
31/12/X3	$(1+0.06)^3$	1.191016

Step 3: Calculate the present value

The present value at 01/01/X1 is calculated by dividing each cashflow by the relevant discount factor.

Date	Lease payment	Present value calculation	Discounted amount
	£		£
31/12/X1	120,000	120,000/1.060	113,208
31/12/X2	120,000	120,000/1.1236	106,799
31/12/X3	120,000	120,000/1.191016	100,754
	360,000		**320,761**