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Corporate Intangibles Research and Development Manual

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CIRD27020 - Leasing of intangible assets: accountancy background

FRS102 s20/IAS17/FRS105 s15/SSAP21 and intangibles

This paragraph gives a very brief outline of the accounting background as a reminder of the salient points for those who have previous knowledge of the accountancy. Newcomers to lease accounting should read the relevant parts of the Business Leasing Manual before looking at subsequent paragraphs in this manual.

GAAP divides leases into two categories, ‘finance’ leases and ‘operating’ leases. A lease for this purpose is any hiring of an asset, including an agreement described as a licence for the use of rights derived from an intangible asset.

A lease is treated as a finance lease for accounting purposes if it is one which transfers substantially all the risks and rewards of ownership of an asset from the lessor to the lessee. A finance lease is accounted for as a loan from lessor to lessee to fund the acquisition of the leased asset by the lessee.

The amount regarded as the loan appears as an asset in the balance sheet of the finance lessor and rental receipts are treated partly as repayment of that loan and partly as interest on it. Conversely, the lessee treats the amount regarded as a loan as a liability and records a similar amount as the value of the leased asset on the other side of the balance sheet. Rentals are again split into interest and repayments of principal while the asset is depreciated in the same way as other assets which the lessee legally owns.

A lease which is not a finance lease is classed an operating lease. Rentals paid and received are simply taken to the profit and loss account as the expense/income accrues which is not necessarily when rentals are paid/received.

A hire purchase contract (which is simply a lease where the lessee has an option to purchase the legal title of the asset on fulfilment of the conditions in the contract, normally the making of an agreed number of payments) is accounted for as a lease. Most hire purchase contracts will be regarded as finance leases.

Companies reporting under IFRS or FRS 101 will have to use IFRS 16 for accounting periods beginning on or after 1 January 2019 (earlier adoption is available). IFRS 16 has a single lessee accounting model that requires assets and liabilities arising from all but exempt lease agreements to be recognised on the balance sheet. The lessee will recognise an asset reflecting their right to use the leased asset for the lease term and a lease liability reflecting their obligation to make lease payments. Both the right-of-use (ROU) asset and lease liability will be recognised at the commencement of the lease.

The ROU asset is depreciated, normally on a straight line basis, over the lease term. The interest on the lease liability is recognised so as to maintain a constant rate on the outstanding lease liability. Depreciation and interest on the lease liability are both recognised in the profit and loss account.

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