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FRS 102 – Proposed lease accounting changes

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Accounting, valuation & tax impacts of the proposed lease accounting changes included in FRED 82 (Amendments to FRS 102) on companies reporting under FRS 102 in the Energy & Natural Resources sector

FRED 82 proposes, among other changes, to align lease accounting under FRS 102 closer to IFRS 16 accounting. This would result in a greater number of leases being accounted for on-balance sheet compared to the current outcomes under FRS 102.

FRED 82

The amendments in the Financial Reporting Exposure Draft ('FRED') 82 have an anticipated effective date for accounting periods beginning on or after 1 January 2026. FRED 82 proposes amendments to FRS 102 to reflect recent changes in IFRS standards, most predominantly, the revenue and lease standards.

Energy & Natural Resources ('ENR') sector entities reporting under FRS 102 – The Financial Reporting Standard applicable in the UK and Republic of Ireland – may currently apply lease accounting for shipping/transport contracts, mining services/construction contracts, rental contracts, power purchase contracts, service contracts which include use of assets, etc. depending on the terms of the agreement and the nature of the assets[(a)].

This brief publication provides a high-level overview of the accounting, valuation & tax impacts of the proposed changes to lease accounting, in FRED 82, for companies in the ENR sector currently reporting under FRS 102.

How will lease accounting change?

IFRS 16 became effective on 1 January 2019 for IFRS preparers. It introduced an on-balance sheet model for lessees to recognise assets and liabilities. This is intended to provide a more faithful representation of leasing transactions, as well as information which is more useful to users of the financial statements.

FRED 82 mirrors this approach. If existing operating leases under FRS 102 are brought on-balance sheet under FRED 82, companies will recognise a lease liability reflecting the entity's obligation to make lease payments over the lease term and a corresponding right-of-use asset that is depreciated over the lease term, unless the leases are considered to be short-term (12 months or less) or relate to low-value items.

The lease liability is measured at amortised cost using the effective interest rate. This results in a front-loaded pattern of lease expense recognition, even when lease payments are of consistent timing and value. Operating lease expenses would be replaced with a combination of depreciation and interest expenses arising from the recognition of a right-of-use asset and an obligation to make lease payments respectively, on the balance sheet.

Impacts on financial ratios

The proposed changes to lease accounting under FRS 102 will generally result in increases to both total assets and total liabilities (hence gearing), decreases in operating expenses, increases in depreciation and interest expenses, and increases to EBITDA.

Statements of cash flows will, expectedly, also be impacted. Generally, cashflows from operating activities and financing activities will increase and decrease respectively. It is important to note that the actual cash flows in lease arrangements will not change; only the classification changes.

The table below summarises the anticipated impacts:

Income statement		Balance sheet		Cash Flows	
Operating expenses	↓	Total assets	↑	Operating activities	↑
Interest expense	↑	Total liabilities	↑	Financing activities	↓
Depreciation expense	↑				
EBITDA	↑				

Note: (a) Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources continue to be excluded from FRS 102.

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Simplifications for the lease accounting changes proposed under FRED 82

Although FRED 82 proposes accounting changes that are generally aligned with IFRS 16, certain lease accounting simplifications have also been provided.

A key simplification is with respect to discount rates. IFRS 16 requires the use of an 'IBR' (Incremental Borrowing Rate) where the rate implicit in the lease is indeterminable. However, FRED 82 proposes the option for entities to use an 'OBR' (Obtainable Borrowing Rate), a less sophisticated version of the IBR. The standard also includes a backstop for entities to use gilt rates where neither the IBR or OBR are available. However, the FRC expects this to be applicable only in limited circumstances.

FRED 82 is also structured such that: fewer lease modifications will require a new discount rate to be determined; the low-value lease exemption offers an option to use the asset value at the start of the lease (rather than when new) and accounting policy choices in relation to sale and leaseback transactions have been simplified.

Other simplifications include those related to lease agreements with multiple components and variable lease payments. In relation to the latter, this implies that entities are only required to include, in the measurement of their lease liabilities, variable lease payments that depend on an index or a rate (e.g., payments linked to a consumer price index or a benchmark interest rate or payments which vary to reflect changes in market rents.

However, these simplifications to IFRS 16 are optional and entities may still apply IFRS 16 requirements if they so wish.

Guidance on lease definition and, lease term are generally anticipated to be aligned to IFRS 16 with limited simplifications.

Due to complications arising from the use of the fully retrospective method under IFRS 16, the FRC proposes only the implementation of a simplified transition approach whereby assets and liabilities are recognised based on the outstanding lease payments and remaining lease term at the date of transition without retrospective application. The FRC has also proposed a simplification whereby entities can use, if available, IFRS 16 balances from their group reporting to IFRS parents.

In the case of IFRS-parented companies, a transitional adjustment, which would be taken to equity, could therefore arise on the adoption of the revised lease standard. This is considered further in the discussion of tax issues on page 4.

New lease definition – is there a lease in the contract?

Given that contracts that are determined to be leases will now be on-balance sheet for lessees, a key consideration for ENR entities would be how the lease definition is applied to their contracts. Consequently, contracts (or relevant contract components) not meeting the lease definition will have to be accounted for as executory contracts.

While, on the surface, the lease definition under FRED 82 appears to be somewhat consistent with the current FRS 102 definition, there are some important changes which could give rise to key accounting judgements.

FRED 82 defines a lease as a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

A contract contains a lease only if it relates to an identified asset. An identified asset is either explicitly or implicitly identified in a contract. A portion of the capacity of an asset (e.g. co-mingled gas storage or shared pipelines and warehouse storage facilities for mined or refined products for oil & gas entities, fibre optic cables for power & utilities companies, etc.) can be an identified asset if it is physically distinct.

Similar to existing guidance, even if an asset is specified in the contract, the customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset during the arrangement (e.g. haulage contracts involving the use of a large fleet of similar trucks or train carriages in the mining or chemicals industry). FRED 82 expands on what constitutes a substantive right to substitute and clarifies that the lessor has to have both the practical ability to substitute the asset and must benefit economically from exercising its right to substitute the asset.

Whether the lessor has the substantive right to substitute the asset may depend upon where the asset is located and the cost to make a replacement asset available. The alternate asset to be substituted must be readily available within a reasonable period of time for the right to be substantive.

Once it is confirmed that there is an identified asset in the contract, the analysis moves to whether the customer controls the use of the identified asset throughout the term of the contract.

While FRS 102 simply focuses on the right to use an asset for an agreed period of time, FRED 82 requires a lessee to have the right to obtain substantially all of the output of an asset and to direct the use of an asset in order to meet the definition of a lease. The latter criteria (i.e. ability to direct the use of an asset) will be one of the significant new judgment areas that will arise from the proposed lease accounting changes to FRS 102 for some ENR entities.

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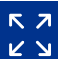
New lease definition – is there a lease in the contract?

Specifications around the operation of assets such as pipelines, drilling rigs, power-generating facilities, processing plants, transportation facilities and other equipment will require further assessment. This is likely to mean that some agreements, that are currently treated as leases by ENR entities, will no longer be when FRED 82 becomes effective given the higher threshold that would need to be crossed to meet the lease definition under FRED 82.

Some potential industry-specific impacts



Capacity portions

Determining whether a specified capacity of a pipeline is physically distinct will continue to be challenging for oil & gas and chemicals companies under FRED 82. If a customer uses or has rights to use substantially all of the capacity of the entire pipeline, the pipeline may constitute an identified asset.

However, for customers whose firm committed volumes represent only a portion of the capacity, it will be more difficult to conclude there is an identified asset. In addition, capacity of different legs of a pipeline or the pipeline, in its entirety, may also vary, further complicating the assessment of whether the asset is physically distinct as well as the unit of account for the accounting assessment.

Joint arrangements

One of the biggest technical and practical challenges for entities in the oil & gas and mining industries is identifying the customer in a contract for the use of assets by a joint arrangement. For example, is the joint arrangement or another party – e.g. an operator – the customer in the contract with the asset supplier?

This assessment is critical to determining whether there is a lease and hence, the accounting treatments for each of the parties to the joint arrangement.

Power Purchase Agreements

Power purchase agreements ('PPAs') are common in the power sector, and represent agreements between a power generator (supplier) and a purchaser (customer) for the sale and supply of energy produced from a renewable power plant such as a solar or wind farm. The PPAs can be physical (i.e., involves the physical delivery of electricity through the grid or private wire) or virtual (i.e. no electricity flows to the buyer but purely a financial instrument such as a contract for difference). Determining whether PPAs contain leases under FRED 82 could involve greater judgement compared to current FRS 102 lease accounting.

For example, when assessing whether a lease exists in a wind farm PPA, considerations may include:

- Identified asset: does the supplier have another facility that could be used to fulfil its PPA obligations, or does the PPA specify a particular wind farm must be used to fulfil the obligations?
- Substantially all economic benefits: economic benefits generated by a wind farm might include power and renewable energy certificates generated through its use. Assessing whether a customer has rights to substantially all economic benefits may be difficult, such as in 'gross pool' electricity markets where all purchases and sales of electricity are settled at spot prices via a market operator that acts as a clearing house for energy transactions. In other words, there exists, between the power generator and customer, no bilateral contractual agreement which is physically deliverable.
- Right to direct the use: the customer will have the rights to direct the use the asset if it has the right to direct how and for what purpose the wind farm is being used though out the period of use. Therefore, considerations would need to be given to decisions around capital expenditures, operations and maintenance, curtailment and asset retirement of the wind farm facility. Under circumstances where decisions about how and for what purpose is used might be predetermined for wind farms, the focus would be on whether the customer has the right to operate the wind farm (or direct others to operate it in a manner it determines) or the customer designed the wind farm in a way that predetermines the how and for what purpose it would be used throughout the period of use.

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Tax impacts

KPMG expects that the tax impacts of FRED 82 on FRS 102 will be very similar to those arising when IFRS 16 was adopted in 2019:

- Specific tax legislation was put in place in 2019 to deal with right-of-use leases. We expect that the majority of this legislation will apply without change to right-of-use leases under FRS102.
- In 2019, some lessees had to conduct a major exercise to consider the tax impact of transitional adjustments including deferred tax issues. While similar issues are expected with FRED 82, for group entities whose parent companies are already applying IFRS (hence IFRS 16), transitional adjustments will only arise for the FRS 102 reporting entities within the group.
- Early adopters of IFRS 16 faced more tax complexity as the FA 2019 rules replaced an earlier tax provision on lease accounting. This issue should not recur as the required tax rules are now in place.
- The other tax impacts broadly bring right-of-use leases in line with existing finance lease tax treatment.
- We note that new agreements (such as PPAs) entered into after the adoption of FRED 82 may give rise to lower capital allowances entitlement compared to the current position for “long funding” operating leases. The impact of this difference will be magnified where full expensing capital allowances treatment is available.
- Corporate interest restriction calculations are not materially impacted as they continue to treat the finance charge as non-interest unless a right-of-use lease would be/have been a finance lease.

Valuation impacts

As earlier noted, the annual rental expense previously included in operating income will now be replaced by depreciation charge and interest expense. As a result, under FRED 82, a company’s EBITDA and EBIT will generally increase which, in turn, may result in a company’s gearing ratios and valuation multiples such as Enterprise Value/EBITDA significantly changing. Great care will be needed to ensure that valuation cash flows and metrics are applied consistently between companies that have and have not adopted FRED 82 or IFRS 16.

The above changes will have an impact on a company’s approach to impairment testing. Prior to adoption, when considering a Discounted Cash Flow (DCF), Value-in-Use (VIU) or Fair Value Less Cost of Disposal (FVLCD) approaches to impairment testing, operating lease payments were treated as an operating expense included in operating cash flows. Following adoption of FRED 82, lease payments will now be classified as financing cash flows resulting in increased EBITDA (and free cash flow). Care will need to be taken to determine an appropriate discount rate which considers an increased ‘leverage’ towards lease debt financing. Simply using the same discount rate, which was determined before the adoption of FRED 82, on the new cash flows may result in inappropriate impairment conclusions.

Wider potential business impacts

Needless to say, FRED 82 will also have broader business impacts. Some of these include the following:

- Lease data requirements – these will increase given that operating leases have historically been off-balance sheet. Increased disclosure requirements will require additional data collection.
- IT systems & processes – may be impacted and need to be redesigned to gather and process the required information.
- Reporting alignment – there would be the need to align reporting requirements within the group e.g. among legal entities, consolidated group entities as well as for management reporting purposes.
- Lease negotiations – while accounting should not be the key driver in commercial negotiations, market behaviour might change towards lease arrangements to minimise lease liabilities.
- Debt covenants & performance metrics – these might need to be renegotiated.
- Dividend policy – the revised profile of the income statement might affect the ability to pay dividends.
- Future transactions – decisions such as (re)financing or raising capital to fund growth, mergers and acquisitions and lease versus buy options are expected to be impacted. Also, for contemplated capital market transactions, the effects on leverage/gearing ratios and specific regulatory requirements regarding presentation of historical financial information will need to be considered.

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Next steps

Similar to IFRS 16, the proposed lease accounting changes included in FRED 82, may require substantial effort to identify all lease agreements and extract all relevant lease data. Careful consideration, early on, will help minimise the compliance cost associated with the adoption of the changes to FRS 102.

More judgment will be required in determining whether certain arrangements are in the scope of IFRS 16 and processes will change for recording leases. Investors and Boards will want to understand the impact of the adoption of the standard on the business, especially to key ratios and reporting metrics.

We would be delighted to meet with you to share our insights and experience with evaluating the requirements of FRED 82's proposed changes to FRS 102 lease accounting.

How can we help?

KPMG can help support your transition to FRED 82's proposed lease accounting in various ways:

- Training/workshops – We can provide in-person or virtual classroom training or workshops tailored for finance teams and support you with understanding the new requirements while applying them to your business.
- Accounting impact assessment – We can support with evaluating the potential impacts of the proposed lease requirements on your financial statements.
- Financial modelling – We can build a model for your leases to calculate the impact of implementing the requirements of the FRED 82 proposals and prepare the required journal entries.
- Determining discount rates – We can support you in determining an appropriate discount rate for your leases.
- Accounting policies – We can prepare/review your leasing accounting policies.
- Disclosure requirements – We can identify how the proposed changes to disclosure requirements will impact your entity and can assist with updating the existing disclosures to comply with the proposed changes.
- Tax – We can perform a tax impact assessment and support with the implementation of the transition.

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