

Assignment of Financial Reporting 1 2018 – FRS 102 AND IFRS 16



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1. Executive Summary

This article will first explain the way FRS 102 distinguishes and calculates leases (only take lessee as example), and secondly analyzes the reasons for using the standard FRS 102 in the current situation and its advantages and disadvantages. Finally, a brief summary of the upcoming new lease IFRS 16 and an analysis of its impact on the company's financial statements.

2. Introduction

2.1. Background

FRS 102 is the most important accounting standard currently implemented in the UK GAAP (Generally Accepted Accounting Principles) for the UK and the Republic of Ireland. The standard was published on March 14, 2013, and its terms and conditions became effective after January 1, 2015. (Mcquaid, 2014)

In January 2016, the IASB issued a new leasing standard, IFRS 16, which has significant differences in the handling of leasing with FRS 102. This standard will be implemented on January 1, 2019.

2.2. Leases under FRS 102

This section describes the definitions of the two forms of leases and how they are calculated in accounting under the existing standard FRS 102.

In the section 20 in FRS 102, there is a classification of leases:

20.4. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to

ownership. (FRCouncil, 2013)

This paragraph tells us that the first principle of determining whether a lease is financing or operating is based on the substance of the lease, that is, who considers the risks and rewards of ownership of the leased asset.

It will result in a finance lease when all risks and rewards attached to the ownership of the asset are essentially transferred from the lessor to the lessee. The asset will appear in the company's balance sheet (financial status table) along with the corresponding finance lease creditor. If the risks and rewards of ownership are still borne by the lessor, the lease is classified as an operating lease and the rental is recognized in profit or loss in the period in which it is incurred. This is the same accounting process as SSAP 21 (and FRSSE (effective April 2008)).

There is a 90% test in SSAP 21, which would result in a finance lease if the present value of the minimum lease payment that the lessee needs to pay is equal to 90% or more of the fair value of the leased asset. However, there is no similar 90% benchmark in SSAP 21 in Section 20; instead, it provides some separate or combined examples to illustrate what kind of lease will be classified as a finance lease, while the other three cases are either Combinations may also result in leases being classified as finance leases. (Mccarthy, 2013)

In FRS 102, the word "substantially all" was used in many places, which replaced the 90% standard in SSAP 21. This requires the accountant to have a judgment on the substance of the lease. (Collings, 2013)

3. Main Body

3.1. Current accounting standards -- FRS 102

3.1.1. Calculation of finance leases

When a lease is a finance lease, we will take the following measures when accounting for accounting. At the beginning of the lease, we have to do initial accounting. The initial accounting is that the lessee should capitalize the finance leased asset and set up a lease liability for the value of the asset recognized. The accounting for this will be: **Dr Non-current assets , Cr Finance lease liability**.

Following the initial capitalization of the leased asset, depreciation should be charged on the asset over the shorter of the lease term or the useful economic life of the asset. The accounting for this will be: **Dr Depreciation expense, Cr Accumulated depreciation**.

There will also be lease rental/interest in subsequent accounting. When a company pays a rental, in effect it is making a capital repayment (ie against the lease obligation) and an interest payment. The impact of this will need to be shown within the financial statements in the form of a finance cost in the statement of profit or loss and a reduction of the outstanding liability in the statement of financial position. (Collings, 2017)

3.1.2. Calculation of operating leases

As the risks and rewards of ownership of an asset are not transferred in the case of an operating lease, an asset is not recognized in the statement of financial position. Instead rentals under operating leases are charged to the statement of profit or loss on

a straight-line basis over the term of the lease, any difference between amounts charged and amounts paid will be prepayments or accruals. (Mullen, 2015)

To give a simple example, suppose a company leases a machine with an estimated life of 10 years. The lease period is four years and the annual rent is \$5,000, starting in January 2018. The machine is expected to have zero residual value at the end of its useful life. The machine's fair value at the beginning of the lease is \$50,000. When this transaction is classified as an operating lease, the accounting treatment for the lease should be relatively simple, as follows: \$5,000 for rent paid on January 1st:

Dr Lease expense (statement of profit or loss)	5,000
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Cr Bank	5,000
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On May 30, 2018, the record is:

Dr Prepayments	2,500
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Cr Lease expense	2,500
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Statement of profit or loss extract

Lease expense	2,500
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Statement of financial position extract

Current assets

Prepayments	2,500
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(ACCA, 2017)

3.1.3. Analysis of FRS 102

In the past, people used FRS 102 as their accounting standard, and they were able to make their own choices when dealing with leasing issues, whether a lease was treated as an operating lease or a finance lease. When a company needs a better financial statement or some metrics, they choose between the two options that are more beneficial to them, rather than the choices made based on actual conditions. This makes it impossible for investors to understand the company's real financial status when consulting the company's financial statements, which is not conducive to the company's financial transparency. (Baker, 2013)

The IASB has looked at lease classification in the context of the Conceptual Framework for Financial Statements and concluded that an asset subject to an operating will meet the definition of an asset because the lessee has the right to use the asset and enjoy economic benefits generated from that use. On the flip side it also meets the definition of a liability because the lessee has obligations to pay the lessor lease rentals, hence should appear on the face of the balance sheet. (Penny, 2013)

3.2. Accounting standards to be implemented -- IFRS 16

From January 1, 2019, the new lease standard IFRS 16 came into effect. This is the latest rental standard issued by the IASB and is quite different from the provisions on leasing in FRS 102. The following is some introduction to IFRS.

IFRS 16 stipulates that leases with a maturity of less than 12 months or a small amount can be accounted for in accordance with the original operating lease. All other leases are subject to financial leasing. That is, at the initial confirmation, the lessee

needs to recognize the leased asset as the lessee's assets, and subsequently depreciation is required, and the present value of future rent is recognized as liabilities included in the balance sheet. (Collings, 2016)

And the impact it brings is undoubtedly huge.

Impact on the lessee

Except for less than 12 months or the lease of small assets, all other leases will be listed, which will cause the lessee's balance sheet to expand significantly with the current rental lease commitments. In addition, the cost-sharing of the operating lease lessee will be changed from the current straight-line method (the same monthly rent) to the former large and small model in line with the finance lease, ie the lease fee (ie the asset depreciation during the first half of the lease period). The interest rate is higher than the operating lease fee recognized by the straight-line method under the current lease standard.

Impact on the company

①Financial statements and financial indicators: The tenant's assets and liabilities increase at the same time, and the time of confirmation of expenses changes (before and after the small), resulting in many common financial indicators including: asset-liability ratio, current ratio, profit before interest and taxes, net profit , earnings per share, return on net assets, cash flow from operating activities, etc. also changed.

②Business decision: One of the reasons why the lessee chooses to lease instead of buying fixed assets may be to avoid reflecting liabilities on the financial statements. Therefore, the new leasing criteria may affect the “buy or rent” business decisions,

and the lessor's strategy also needs to be adjusted.

③Contracts with other business partners: Changes in financial indicators may require the company to re-negotiate the loan contract with the borrower, re-negotiate the payment credit terms with the supplier, and so on.

④Tax impact: Changes in the way the fee is confirmed may affect the amount and time actually paid by the tax.

⑤Budget: Under the new standard, the tenant's assets, liabilities and expenses will change, which need to be considered in the budget. (admin, 2018)

4. Conclusions

In summary, the past FRS 102 has its own set of treatments about leases, and the release of the new IFRS 16 brings a new concept, which will undoubtedly have a huge impact on the company's financial accounting. Enterprises need to adapt as soon as possible.

5. References

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