

Dummy Report for Financial Reporting Assignment 2018 – Leasing



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MODULE NAME	FINANCIAL REPORTING
NAME	YAO WANG
STUDENT NUMBER	1804591

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1. EXECUTIVE SUMMARY

In FRS 102, lease is mainly divided into operating lease and financing lease, and the difference between the two leases is mainly in title, Residual Amount and running costs and administration. In the financial statements, operating lease is treated as expenses where as a finance lease is included as an asset for the lessee. Of course, the principle that substance is more important than form is also very significant.

Also, there are three reasons for the criticism of the approach adopted by the current accounting standard. In IFRS16, the key change is that all leases are now accounted for in the same way, and it affects not only the profit statement but also the balance sheet and cash flow statement.

2. INTRODUCTION

In this article, the way in which leases are differentiated and accounted for in accordance with FRS 102 will be discussed. The reasons for the criticism of the approach adopted by the current accounting standard and how this treatment conflicts with the principles within the Conceptual Framework will also be discussed. Lastly, summarise concisely the new accounting treatment which has been included in IFRS 16 and discuss the ways in which this will effect on the financial statements of companies.

3. MAIN BODY

3.1 WAYS IN WHICH LEASES ARE DIFFERENTIATED WITH FRS 102

In view of the existing leasing accounting standards, according to FRS 102, the lease is first divided into two types: financial lease and operating lease, and the financial lease is required to be capitalized.

Financial lease is often used to buy equipment for the major part of its useful life. An operating lease agreement to finance equipment for less than its useful life, and

the lessee can return equipment to the lessor at the end of the lease period without any further obligation (Barry Elliott Jamie Elliott, 2013).

The differences between these two leases are mainly in three aspects. First of all is the title, in a finance lease agreement, ownership of the property is transferred to the lessee at the end of the lease term. But, in operating lease agreement, the ownership of the property is retained during and after the lease term by the lessor. Residual amount comes to the second. In finance lease agreement, there is a residual option for the lessee to purchase the property or equipment at a specific price. But, under an operating lease, the lessee does not have this option. The residual on a finance lease is set using ATO asset guidelines. The last aspect is the running costs and administration. Under an operating lease all running costs are included in the lease within the designated term and usage km with one set monthly repayment amount. Under a finance lease these are generally not included meaning there can be greater administration and price fluctuation for the lessee.

When these two leases are accounted for in the financial statements, operating lease is treated as expenses whereas a finance lease is included as an asset for the lessee. Edit: the tax treatment for leases will change in 2019, with operating leases appearing on the balance sheets as liabilities.

The principle that substance is more important than form means that enterprises should conduct accounting according to the economic essence of transactions or events, and not only according to their legal form as the basis of accounting. In practical work, the external or artificial forms of transactions or events can not fully reflect the real content (Barry Elliott Jamie Elliott, 2013).

Therefore, the transactions or events that accounting information intends to reflect must be accounted for according to the essence and economic reality of the transactions or events, not according to their legal forms. For instance, a food-processing company has cash flow problems, so it sells its fleet of delivery trucks to a bank and gets it back on a lease. The transaction is called sale and

leaseback. Although the legal ownership of the assets has transferred but the underlying economics remains the same and hence under the substance over form principle the sale and subsequent leaseback are looked at as one transaction. The company cannot just remove the fleet from its balance sheet because the legal ownership has changed. It will continue to recognize the fleet as an asset and shall also record a lease liability that arise out of the associated lease-back.

3.2 REASONS FOR THE CRITICISM OF THE APPROACH AND HOW THIS TREATMENT CONFLICTS WITH THE PRINCIPLES

There are three reasons for the criticism of the approach adopted by the current accounting standard. Firstly, our current accounting standards stipulate that operating lease is reflected outside the form, and many users believe that operating lease brings assets and liabilities to the lessee, which should be reflected in its financial statements. The information provided in the notes to the financial statements is often insufficient for users to make reliable adjustments. Secondly, the division of two completely different types of leases, financial lease and operating lease, means that similar leasing business uses completely different accounting methods. This makes it impossible for report users to make reasonable comparisons. Thirdly, the current standards provide an opportunity for structured transactions, which enable leases to be identified as selected types. The lessee may freely choose the leasing method which is beneficial to him according to his own needs. For example, if the lease is recognized as an operating lease, the lessee acquires a source of financing that can not be identified in the statement.

After entering a lease contract, the lessee acquires the right to use the leased property, which conforms to the definition of assets. Accordingly, the lessee also has the obligation to pay rent, which also conforms to the definition of liability. However, if

the lessee recognizes the lease as an operating lease, neither assets nor liabilities can be recognized.

3.3 SUMMARISE THE NEW ACCOUNTING TREATMENT IN IFRS 16 AND DISCUSS THE WAYS

The new accounting treatment which has been included in IFRS 16 is the change in the measurement way. In view of the different accounting methods used by the lessee to distinguish between real estate and real estate, IFRS16 determines that only a single measurement method is used (Blake John, 2007).

Specific measurement methods are: for the lessee, financial lease and operating lease will no longer be separated, but use the same method to deal with. Leased assets and leased liabilities caused by leasing need to be recognized on the balance sheet by the present value of unavoidable future payments; interest on rented assets and liabilities should also be reflected in the profit sheet; total cash is divided into main parts and interest reflected in the balance sheet. However, considering the convenience of leasing for SMEs, if an asset is leased for a short period of time within December without any renewal right, the leased asset need not be reflected in the financial statements. At the same time, assets with a lesser lease amount (less than 5,000 yuan) need not be reflected in the financial statements (Blake John, 2007).

In the negative investigative statement of assets, because the information stated in the notes of the original operating lease is "listed above", this will result in a new part of assets and liabilities, while the owner's equity will decline. Among them, the book value of the lease liabilities should be determined by the present value of the lease payments payable in the future, and the interest rate of the new loan should be used to confirm the interest in the subsequent measurement; the leased assets should be accounted for by the sum of the amount of the lease liabilities and other direct costs, and then the subsequent measurement should be carried out according to the

depreciation method of the fixed assets standard. Because the determination of assets is one more expense than liabilities, the book reduction of leased assets in each period will be more than the change of liabilities in each period, in other words, the depreciation in each period will be more than the interest recognized in each period. Accordingly, this will lead to the decline of owner's equity at the end of the relevant accounting period.

For cash flow statement, the original business lease project should be included in the cash expenditure of business activities. Now the expenditure of the principal part will be included in the financing activities. The expenditure of the interest part can be accounted for the cash flow of business activities or financing activities according to the circumstances. The cash flow of business activities will certainly change, which reflects the change of intermediary business and profitability, at the same time, it will affect the cash flow-debt ratio of enterprises, reflecting the change of debt-paying ability of enterprises.

4. CONCLUSION

Generally speaking, this paper first describes the types of leases in FRS102 and how to record them in financial statements, and emphasizes the application of the principle that substance is more important than form. Then three reasons are analyzed. Finally, the main new change of leasing in IFRS16 is that all leases are recorded in the same way and have an impact on the various financial statements.

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