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

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MODULE NAME: **FINANCIAL REPORTING**

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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.

A finance lease occurs when all the risks and rewards attached to the ownership of an asset are substantially transferred from the lessor to the lessee. The assets will appear on the company's balance sheet (balance sheet) together with the corresponding finance lease creditors. If the risks and rewards of ownership are still borne by the lessor, the lease is classified as an operating lease, and the lease is recognized in the profit and loss during its generation. This is the same accounting process as SSAP 21. (and FRSSE (effective April 2008)).

In 90% of the tests in SSAP 21, 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, it will lead to financial leasing. However, SSAP 21 in section 20 does not have a similar 90% benchmark; Instead, it provides examples of individual or combination cases to illustrate what kind of lease will be classified as a finance lease. (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 rent, it is in effect repaying capital (ie, a breach of lease obligation) and interest payments. The impact needs to be shown in the financial statements in the form of reduced financing costs in the income statement and reduced outstanding liabilities in the financial position statement. (Collings, 2017)

3.1.2. Calculation of operating leases

Since the risks and rewards of ownership of an asset are not transferred in the case of an operating lease, the asset is not recognized in the statement of financial position. On the contrary, the rent under the operating lease shall be recorded in the income statement on a straight-line basis during the lease term, and the difference

between the amount received and the amount paid shall be the advance payment or accrued expenses. (Mullen, 2015)

For a simple example, suppose a company leases a machine with an estimated life of 10 years. The lease will run for four years for $5,000 a year, starting in January 2018.The residual value of the machine is expected to be zero at the end of its useful life. The fair value of the machine at the beginning of the lease is $50,000.When this transaction is classified as an operating lease, the accounting of the lease is supposed to be relatively simple, as follows: $5,000 for rent paid on January 1st:

Dr Lease expense (statement of profit or loss)		**5,000**
Cr Bank		**5,000**

On May 30, 2018, the record is:

Dr Prepayments	**2,500**	
Cr Lease expense	**2,500**	
Statement of profit or loss extract		
Lease expense		**2,500**
Statement of financial position extract		
Current assets		
Prepayments		**2,500**

(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)

ISAB considered the classification of leases in the context of the conceptual framework of financial statements and concluded that the assets operated would meet the definition of an asset, since the lessee was entitled to use the assets and to enjoy the resulting economic benefits. On the other hand, it also conforms to the definition of liability, because the lessee has the obligation to pay the lessor rent, and therefore should appear on 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 no. 16 provides that leases with a maturity of less than 12 months or a small number of months may be recorded under the original operating lease. All other leases require a finance lease. That means, at the initial recognition, the lessee needs to

recognize the leased asset as the lessee's asset, and then it needs depreciation, and the present value of the future rent is recognized as the liability 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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