

***Financial Reporting Assignment 1 2018 –
Lease Accounting***



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1. EXECUTIVE SUMMARY

According to FRS 102, leases are currently classified into finance leases and operating leases, the distinction between these two leases lies in finance leases transfer all the risks and rewards incidental to ownership, while operating leases do not. Different accounting methods such as measurement, recognition, depreciation and disclosures are applied to the two kinds of leases.

However, it has been criticised for years that the current standard has a conflict between IASB conceptual framework and whether the financial information is truly reflected is also doubted since the current treatment of operating leases contradicts the definition of assets in the conceptual framework and a large amount of assets may only be represented in off-balance sheet, which may mislead the users of financial statements. Additionally, the judgment on the classification of leases is rather subjective and similar transactions may be dealt with differently and results in less faithful financial information and a lack of comparability.

Therefore, a new lease standard was released in 2016 and will come into effect in 2019, which adopts the concept of 'right of use' and abolishes the distinction between operating leases and finance leases. Disclosures requirements are changed and more faithful financial information will be represented. New accounting standards also have impacts on the financial status, operating results and cash flow performances.

2.INTRODUCTION

The main aim of this report is to demonstrate the current standards of lease accounting in accordance with FRS 102 and arguments about the problems in current standards from different aspects. The new accounting treatment in IFRS 16 is also discussed in this report, which makes significant changes in lease accounting and improves existing issues

3.MAIN FINDINGS

3.1 LEASES IN ACCORDANCE WITH FRS 102

3.1.1 CLASSIFICATION OF LEASES

According to FRS 102 (icaew 2018), leases can be classified into finance leases and operating leases based on whether all the risks and rewards incidental to ownership are transferred substantially. The former one transfers all the risks and rewards in substance, while the latter one does not (icaew 2018).

And leases adopt the principle of substance over form and apply it to accounting of leases in different cases (accaglobal 2018), which means transactions should be accounted in accordance with economic substance instead of the form of contract (accaglobal 2018)

3.1.2 DIFFERENT FINANCIAL STATEMENTS OF LESSEES

3.1.2.1 RECOGNITION AND MEASUREMENT

Finance lease divides the recognition and measurement into two parts: initial and subsequent. In initial accounting, the lessee should capitalize the finance leased asset and the right of use and obligations under finance leases should be recognised as assets and liabilities in the statement of financial position at the lower of the fair value of the leased assets or the present value of the minimum lease payments (icawe 2018).

The accounting for initial accounting (accaglobal 2018):

DR Non-current assets

CR Finance lease liability

In subsequent accounting, the lessee shall use the effect interest method to apportion the minimum lease payments between the financial charge and the reduction of the outstanding liability. The assets also shall be fully depreciated over the shorter of its useful economic life

and the lease term if it is not certain that the lessee will obtain ownership at the end of the finance lease term (icawe 2018).

The accounting for depreciation (accaglobal 2018):

DR Depreciation expense

CR Accumulated depreciation

However, in the case of operating lease, since the risks and rewards incidental to ownership are not transferred substantially, assets are not recognised in the statement of financial position (accaglobal 2018). And instead, lease payments under operating leases (excluding costs of service such as maintenance and insurance) should be recognised as an expense over the term of lease on a straight-line basis (iaew 2018).

The accounting for lease expense (accaglobal 2018):

DR Lease expense (statement of profit or loss)

CR Bank

3.1.2.2 DISCLOSURES

For each of the following periods: (i) not later than one year; (ii) later than one year and not later than five years; (iii) later than five years, lessees shall make the disclosures of the total future minimum lease payments for finance lease at the end of the reporting period, while for operating lease, a lessee shall make the disclosures of the total future minimum lease payments under non-cancellable operating leases for the same periods mentioned above(icaew 2018).

Besides, for finance leases, a lessee shall make disclosures of the net carrying amount of each category of asset at the end of the reporting period and a broad description of the lessee's important leasing agreements. While for operating leases, a lessee need to make disclosures that lease payments are recognised as expense (icaew 2018).

3.2 REASONS FOR CRITICISM

3.2.1 CONFLICTS WITH CONCEPTUAL FRAMEWORK

According to Conceptual Framework issued by IASB, an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity (IASB 2018). Since an operating lease contract is signed in the previous period and during the agreed lease period, the lessee is able to produce products, provide services externally and generate corresponding cash flows by using leased objects (Ron van Kints, R.E.G.A, 2018). That is to say, operating leases meet the definition of assets, while in accordance with FRS102, an operating lease does not confirm the assets and liabilities associated with the lease, which is also called off-balance sheet lease (Joubert 2017). From the perspective of financial theory, it is obvious that these two standards are contradictory on the issue of operating leases (Smit 2013).

3.2.2 LACK OF COMPARABILITY

According to current reporting standards (FRS 102), financial lease must be implemented on the balance sheet while operating lease can be presented off-balance sheet, which means similar transactions may be accounted differently (Harris 2013) and this flexibility can lead to a lack of comparability and relativity in lease reporting (Hsieh 2015). Additionally, the difference between financing lease and operating lease is vague and subtle, which means different accounting methods for leases can be based on relatively subjective and unsure judgment, and this may lead to a reduction in credibility of financial statements (Harris 2013) .

3.2.3 INSUFFICIENT INFORMATION

Another issue in lease accounting is that operating leases underestimate the amount of lessee's assets and liabilities, which makes financial statements unable to reflect the true financial situation of the enterprises (Dhaliwal 2011), which means the entity can create a false picture and hide financial transactions from users instead of giving them a faithful information (Lightner 2013). For the lessee, especially for companies that are highly dependent on the leased asset, a large amount of leased assets are not reflected in the financial statements, which affects the financial reporting users' decisions including potential

investors. At the same time, enterprises with higher asset-liability ratios are more inclined to use the form of operating leases, which not only obtains the right to use the assets, but also avoids the risk of raising the asset-liability ratio (Nicolae 2017). Although the lessee must disclose the details of operating leases in the notes to the statement, it still has a certain impact on the investor's analysis of the financial information of the company (Osei 2017).

3.3 THE NEW TREATMENT

3.3.1 MAIN CHANGES

IFRS 16 – Leases, which will substitute IAS17, was issued by the IASB in January 16 and comes into effect on January 2019. Significant changes are made to how leasing are reported in the financial statements (accaglobal 2018).

3.3.1.1 IDENTIFICATION OF LEASES

According to IFRS 16, a lease is defined as “A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration” (iasplus 2018). That is to say, the existence of a lease is decided by whether the lessee control the use of the identified lease assets and obtain substantially all economic benefits during the lease term (Teng 2018).

3.3.1.2 ACCOUNTING METHODS

The concept of “right of use asset” abolishes the distinction between finance and operating leases, and therefore all leases are recognised as lease assets and liabilities in the financial statements, except for short-term and small leases (Joubert 2017). And subsequently, the right of use asset is depreciated over the shorter of the lease term and the useful life of the asset. (accaglobal 2018)

3.3.1.3 DISCLOSURES

The new standard IFRS16 does not list disclosed items as the current standard, but proposes that the information disclosure is to enable the both parties to combine the on- and off-balance information to help the information users better understand the financial status, operating results and cash flow of the leasing business. The principled objectives require companies to provide faithful and appropriate information (Teng 2018).

3.3.2 POTENTIAL IMPACTS

3.3.2.1 FINANCIAL STATUS

The right-of-use assets are initially recognised as non-current assets and the right-of-use liabilities are classified as current and non-current liabilities, which leads to changes in the internal structure of the balance sheet, while the asset-liability ratio rises and the current ratio decreases(Osei 2017).

3.3.2.2 OPERATING RESULTS

When the new standard is compared with the current standard, the pre-tax profit before income tax, operating profit and financing expenses are higher than the latter; the pre-tax profit of former in the earlier period is lower than the latter, and the former is higher than the latter in the later period (Osei 2017).

3.3.2.3 CASH FLOW

Compared with the current standard, the new standard has increased net cash flow from operating activities and decreased net cash flow from financing activities(Teng 2018).

3.3.2.4 FINANCIAL INFORMATION

The new standard reflects the both leasing business on the lessee's balance sheet according to the unified standard, so that the capital structure and financial strength of the enterprise can

be faithfully reflected, and enhance the comparability of the financial information of different leasing businesses within and outside the industry, and also improve the financial report information quality of current standard financing lease(Joubert 2017).

4.CONCLUSIONS

Current accounting standard classifies leases into finance leases and operating leases, which does not need to recognise assets and liabilities in the balance sheet and this leads to constant argument. For instance, it conflicts with the conceptual framework on the definition of asset and results in a lack of comparability and insufficient information for users of financial statements. Confronted with these criticism, a new standard IFRS 16 was issued, which extinguishes the difference between finance and operating leases and makes important changes in lease accounting such as identification, accounting methods and disclosure requirements. These changes may reflect more faithful information to the users of financial statements and have impact on financial status of the entity.

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