Reviewing AASB 16

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# Introduction

The Australian Accounting Standard 16 is basically concerned with accounting for leases. This standard has been issued by the AASB which has the responsibility to make and keep the Australian Accounting Standards. The application of these accounting standards to various entities is documented through the AASB 1057 and the application of various tiers for the reporting of financial information is documented through AASB 1053.

## Requirements of this Standard

This standard introduces a model that uses single party that takes on lease and the party that takes on lease is required to identify the resources involved in all the leases having a term of more than 12 months. The only exception are resources which have lower values. This constitutes two parts, a right of use which shows that the party that takes on lease has the option to use the resource under lease and the second part shows liability of the payments made by the party that takes on lease. The right of use is measured in a similar way as it is done in other non-financial resources and lease liability is ascertained in the same way as other financial liabilities. This forces the party that takes on lease to record depreciation related to the resources under lease and the interest on lease liability, repayments on the lease agreement are divided into principal and interest payments. The value of resources and obligations related to leasing are calculated on the basis of present value. This covers the lease payments that cannot be canceled as well as payments made if the party that takes on lease is confirmed to extend in the future. This standard shows the requirements for a party that has leased the resource. This party will be applying judgment in making a decision as to which information will be given in the financial statements so that users of the same information can assess the effects of these transactions on various aspects of the business performance. The accounting requirements of the person who has given an resource on lease are also affected by this accounting standard. This party will account for different kinds of lease agreements namely the operational as well as finance leases. These leases will be handled differently. The lessor is required to improve the information so that the risk is decreased.

## Date of implementation

This standard has been brought to action from January 1, 2019. The entities that apply the AASB 15 can implement this standard before the required date.

## Reason for this standard

For many businesses, leasing constitutes an important aspect of their business. This allows the business to acquire some resources on easier terms. The risks that are associated with the ownership of resources are also avoided with the help of leasing. The involvement of an organization in leasing activity will mean that it has to publish the leasing information in such a way that users of financial statements have a clear picture of what is happening in respect to leasing. The model that was used in the past for leases required that the lessor and party that takes on lease should identify lease as one of the two types namely financial or operational. The model was criticized because it did not provide sufficient information for the users of financial statements. leasing transactions were not clearly shown in financial statements and there was no reliable information on the leasing for users. This drawback was overcome by authorities asking the party that takes on lease to maintain the resources and liabilities that come out of the lease agreements. This approach will update the books of accounts for the party that takes on lease especially the resources and liabilities sections and will provide a better understanding for users, if they are interested in the lease agreements. To summarize the discussion, we can say that the party that takes on lease will apply standard procedures to all the leases and the lessor accounting has been unchanged.

The party that takes on lease is allowed not to apply this standard to short term leases and the leases for which resources are of a lower value.

## Comparison

Most of the companies need a mixed variety of resources to produce a certain level of output or to give a certain kind of service to customers. A company has two options regarding any resource, either to buy or to lease. The lease option does not require that the company makes a huge payment up front. This makes the accounting treatment of the leases a very important topic in the accounting arena.

A lease agreement is a settlement among two entities namely party that takes on lease and lessor. The lessor is the party which has the ownership rights of the resources. In the past, the resources which were leased were not shown on the balance sheet by the lessor and this resulted in any liability also being omitted from the balance sheet. These aspects were known as the off-balance sheet items. Some companies also made some fraudulent acts and kept their liabilities low by showing them in off-balance sheet items. This standard identifies two major types of lease, namely finance lease, and operating lease.

## Finance Lease

This kind of lease puts all the risks and benefits associated with resources on the party taking on lease.

## *Operating Lease*

This is defined as being any lease other than the finance lease.

## *Classification*

This kind of lease can be identified by the information that has been provided in a given scenario. The main aspect that has to be decided is whether the benefits and dangers associated with the lease are with the lessor or party that takes on lease. If both these things are with the party taking on the lease, then it will be considered a finance lease otherwise it will be an operating lease.

## Indicators for a Finance Lease

The prominent discrimination is the fact that party that takes on lease has the privilege of taking advantage of the resource for most or the whole of its economic tenure. The major dangers pertain to the payments regarding insurance, repairs, and maintenance of resources. At the start of the agreement, present value of the lowest value of lease payments is equal to the real value of resources. The lease agreement will transfer rights of the resource to the party that takes on lease at the completion of the lease agreement. The resource which is under consideration is of some specialized nature.

## *Finance lease Accounting*

The party that takes on lease will show the resource as a capital item in books and a liability will be set up for the value of the resource recognized. The resources and liabilities in books will be raised at the same time by recording an resource in the name of non- current resources and creating a liability in the name of the finance lease liability. The value used to record this must be lower to the fair value of resources and the present value of the minimum lease payments.

## *Further accounting considerations*

For depreciation calculations, the lower term of the lease time and the useful economic life of the resource will be used. The depreciation expense will be debited and the accumulated depreciation account is credited.

The lease agreement explicitly shows whether there is any finance cost associated with the lease agreement or not. If actual value of the resource is 10000 and it is leased for four years for a payment of $ 3000 per annum, this shows that there is an extra $ 2000 that has to be paid in terms of the financial cost.

## Land and Building

The economic life of the land is impossible to ascertain, due to this reason the lease of land was treated as operating lease till 2009 unless it was expected that the ownership will be transferred to the other party at the end of the lease. Thus, the land lease can be treated as a finance lease if the existing criteria is fulfilled especially if the dangers and rewards of entitlement can be seen to have been transferred. This will also mean that the present value of the lowest lease payments will almost be equal to the fair value of the land. The building lease will be treated as a finance lease if it satisfies the said requirements.

## Disclosure requirements for party that takes on leases

 The party that takes on leases have to report the net amount they are carrying at the end of the financial reporting period separately for all classes of resources. The party that takes on lease should bring out a consensus in the form of reconciling the lowest lease payments at the reporting date and the present value. This figure should be reported for three distinct time periods namely not later than 1 year, between 1 and 5 years and later than 5 years.

## Operating Lease Accounting

The operating lease does not require that the dangers and rewards are transferred from one party to the other, this means that the resource will not be recognized in the financial statements of the party that takes on lease. The rentals, in this case, are shown in the statement of profit and loss account as an expense. This is done on a straight-line basis over the time period of the lease agreement. difference between the charged amounts and paid amounts will be treated as prepayments and accruals.

## Disclosure requirements

The total of minimum future lease payments for less than one year, for 1 to 5 years and for more than 5 years are disclosed separately.

# New Standard IFRS 16

The old standard has now been replaced by the IFRS 16 with effect from January 1, 2018. The first and foremost distinction between the two is the way in which operating leases will be brought into the balance sheet. Previously the party that takes on lease was allowed to show the resources and liabilities from the operating lease as a footnote to the balance sheet. This caused a certain level of inaccuracy regarding the financial statements in the eyes of external users. Particularly this aspect is related to the expenses that are outstanding on part of the organization. users have to ascertain the off-balance sheet liabilities of the organization failing which will overestimate the value of the organization. The users will not be able to compare the organizations that buy resources to those which lease them if the leased aspects are shown off the balance sheet. The current standard changes the scenario by requiring a party that takes on lease to recognize the resources related to the lease on the balance sheet. This includes both the resources as well as the liabilities associated with the lease agreement. This difference will see a large difference related to various financial metrics when leases are considered.

In the past financial leases were considered as resources and operating leases were considered expenses. The new standard considers all leases as resources.

## Why is it necessary to differentiate?

The changes will allow the users to improve the comparability of the financial statements between organizations that buy an resource and those who take it on lease.

# Impacts

## Financial report impact

The operating leases will be capitalized and the businesses which use more of these leases, the financial metrics for such businesses will change. Various ratios such as resources turnover, equity and operating expenses are likely to see a decrease.

The change in the metrics and ratios will mean that the company will have to take some extra care while explaining the changes in figures. The change may bring out some breaking of agreements and contract whether they are internal or external in nature. This may include the payment to some employees if they achieve some minimum criteria for some ratio. With the change, it may not be possible for them to achieve such minimum criteria. Similar considerations can be made in the case of shareholders and investors.

## Accountant involvement

There will be a considerable impact on changes in the accounting department and those related to accountants. This impact will be more prominent in the first year of reporting after the change. The internal attitude towards leasing will change as they will need to know more about the leases and their treatment in financial statements.

In the old standard, accountants did not have any complex transactions to handle. The volume of operating leases was significantly higher as compared to the finance leases. Thus, a number and complexity of transactions related to leases were low.

According to the new standard, the company has to show all the leases on the balance sheets. Thus, the company will have to get involved in a large number of complex transactions regarding amortizations.

# Company Chosen

The company that we have chosen is Walmart.

Walmart is involved in the leasing of various resources including land, buildings, etc. The valuation of the lease term is done by keeping in view a renewal option where some fine or other punishments exist if the lease is abandoned other than cancellation (Stock-analysis-on-net, 2019). The company reserves the right of such renewal. time involved in any lease will determine whether it is to be treated as a capital lease or operating lease. useful life of the lease is determined by comparing the lease term and economic life of the resource, whichever is lower. changes in rent payments are considered while calculating minimum lease payments.

The company is often involved in constructing required leased stores. Certain payments during the projects show as if Walmart is the owner of the leased resources for accounting purposes. These payments are automatic indicators of ownership regardless of their size and Walmart must capitalize the total costs to the party that takes on lease with financial liability. At the end of the lease term, the company performs an analysis to determine whether the said resources can be written off from the company balance sheet. This is decided based on an assessment if the company sees that it will have a long term concern in the scenario. These resources are amortized over the lease term. At the end of the lease arrangements and any renewal period, the net liability over the net value of the resources is considered as a profit that will not be paid in cash.



## Impact on Walmart

The company had a considerable impact on various ratios after the implementation of the accounting standard. The assessment of the impact is shown in the following table

|  |  |  |
| --- | --- | --- |
| Ratio | Description | Impact |
| Total Resources Turnover | This ration is found by dividing the total revenue by the adjusted value of total resources | The ratio had improved for the company from 2017 to 2018 but the same figure has a decline |
| Debt to Equity | This is calculated by dividing the total debt by total equity.  | This ratio for the company improved from 2017 to 2018 but it again went down from the year 2018 to 2019 |
| Return on resources | This is a profitability ratio that is calculated by dividing the net income by total resources. | This ratio had declined for the company from 2017 to 2018 and from 2018 to 2019 |
| Interest coverage  | This is calculated as the EBIT divided by payments in terms of interest. | This ratio has declined for the company from the year 2017 to 2018 and 2018 to 2019. |

Below, the figures have been presented to justify the statements in the above table.

Total Resources Turnover

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Net Sales | 510329 | 495761 | 481317 | 478614 | 482229 |
| Total Resources | 219295 | 204522 | 198825 | 199581 | 203706 |
| **Resources Turnover Before** | **2.33** | **2.42** | **2.42** | **2.40** | **2.37** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Net Sales | 510329 | 495761 | 481317 | 478614 | 482229 |
| Total Resources | 227828 | 214789 | 210451 | 212920 | 213394 |
| **Resources Turnover After** | **2.24** | **2.31** | **2.29** | **2.25** | **2.26** |

The above tables show a considerable decrease in turnover ratios of total resources in the years 2015 till 2019 when the impact of the lease agreements has been applied. We see that the amount of resources has increased and the ratio has declined in all the years. This shows that the company was having considerable amounts of off-balance sheet items before this standard was in practice.

Debt to Equity

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Total Debt | 58033 | 46487 | 45938 | 50034 | 50381 |
| Total Equity | 72496 | 77869 | 77798 | 80546 | 81394 |
| **Ratio Before** | **0.80** | **0.60** | **0.59** | **0.62** | **0.62** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Total Debt | 66566 | 56754 | 57564 | 63373 | 60069 |
| Total Equity | 72496 | 77869 | 77798 | 80546 | 81394 |
| **Ratio After** | **0.92** | **0.73** | **0.74** | **0.79** | **0.74** |

The above tables show the impact of adoption of the accounting standard. figures show that the ratio has been impacted significantly by adoption of the standard. This also shows that before adoption of the standards, Company had a considerable amount of liabilities which were not shown on the balance sheet of the company. This is shown by the increase in liabilities or debt in the second table. One difference in the first or second table is that in the first table there is an increase for the ratio from the year 2017 to 2018 whereas in the second table the ratio from the year 2017 to 2018 has decreased. Similarly, the ratio in the years 2015 & 2016 have remained the same but in the second table, the ratio has increased over the two years.

Return on Resources

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Net income | 6670 | 9862 | 13643 | 14694 | 16363 |
| Total Resources | 219295 | 204522 | 198825 | 199581 | 203706 |
| **Ratio Before** | **3.04%** | **4.82%** | **6.86%** | **7.36%** | **8.03%** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2019** | **2018** | **2017** | **2016** | **2015** |
| Net Income | 6670 | 9862 | 13643 | 14694 | 16363 |
| Total Resources | 227828 | 214789 | 210451 | 212920 | 213394 |
| **Ratio After** | **2.93%** | **4.59%** | **6.48%** | **6.9%** | **7.67%** |

Above tables show the impact of the adoption of the standard on Walmart in terms of the return on resources. We can notice a clear decline in the return on resources when the standard was adopted. This decline is attributable to the increase in resources which were previously shown off balance Sheet by the company.

# Conclusion

The standard has had a significant impact on the way the companies report the various leases in the balance sheets. This has forced companies to improve completeness of the information presented in the financial statements. This has also allowed users of the information to have better insights in the financial statements especially with reference to certain ratios related to profitability, activity, and solvency. Before the adoption of this standard, certain frauds were reported which were based on the practice of keeping items off balance sheet. This standard will help to avoid such fraud.

# References

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