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Impact of Financial Accounting Standards Board Accounting Standards Update ASU 2016-02 Leases on Amazon Incorporation Economics Models in USA

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Abstract

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) made an update to the Accounting Standards (No. 2016-02) on leases. The update deals with leases, and the new guidelines will impact the procurement and management of corporate leases. Previous lease accounting standards had faced a lot of criticism for not accounting for the financial requirements of those who use financial statements. This prompted the FASB to work to remedy these problems. The ASU 2016- 02 brings with it significant changes to financial statements and processes. This paper looks at Amazon.com Inc. to understand how new standards can be used to address the inconsistencies that arise in the prior guidelines on the reporting of leases. To analyze the change in the reporting of leases, we consider three elements: contingent rent, minimum rent expense, and the deferred rent liability. The changes brought about by the updated accounting standard change the overall value of a company. Corporate analysts mainly pay attention to the composition of the balance sheet and the alignment of the income statement of a company with its balance sheet. In conclusion, the GAAP guidelines on the treatment of leases has corrected the problems that were criticized in the previous guidelines. The ASU 2016- 02 leases have brought major improvement in the way leases are accounted for and will bring with it clear improvements in the estimation of the financial standing of companies. Though it will take some time and money to effectively adopt the guidelines, they will be beneficial to the companies in the long run.

Keywords: *ASU 2016-02, Leases, Amazon, Economics Models*

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1.1 Impact of ASU 2016-02, Leases on the recording of leases

On February 25, 2016, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) made an update to the Accounting Standards (No. 2016-02) on leases. The update deals with leases, and the new guidelines will impact the procurement and management of corporate leases. Previous lease accounting standards had faced a lot of criticism for not accounting for the financial requirements of those who use financial statements. This prompted the FASB to work to remedy these problems. The update will influence the financial statements of all businesses that entail lease agreements and contracts (FASB, 2016).

The biggest difference that the ASU 2016 -02 brings with it is the identification of the right to use and lease liability in the current financial statements, while in the prior guidelines, they were classified under operating leases and financial leases. This classification is guided by the same rules as that of the prior guidelines, but the ASU 2016-02 has more subjective rules. In order for a lessee to classify a lease as a financing lease, the lease has to meet the following criteria at the beginning of its term: the lessee has the right to buy the asset, the length of the lease runs for a notable portion of the assets economic life, the lease has to be transferred to the ownership of the lessor once the tenure of the lease has ended, the value of the asset has to be significantly higher than the lease installments that the lessee pays and any other residual value declared by the lessee and at the end of the term of the lease, the asset is out of the ownership of the lessor (Ernest & Young, 2016) and back to the ownership of the lessee.

If none of the above criteria is met, the lease is classified as an operating lease according to the new guidelines. The ASU 2016- 02 offers companies two ways to report leases; leases can either be operating leases or capital leases. Most companies will likely opt to adopt the operating lease reporting method as it will keep leases out of the balance sheets and will only require leases to be disclosed in the footnotes. Capital lease reporting is more difficult to implement as it will require companies to report both lease liabilities and lease assets on the balance sheet and financial statements (Caskey & Ozel, 2019). The Chamber of Commerce together with other concerned stakeholders commissioned a study to evaluate the changes of the new guidelines to the total liabilities and total assets in the balance sheets of publicly traded companies. The study found that the ASU 2016- 02 leases guidelines would increase the balances of the companies by $1.1 trillion by including the companies' real estate holdings in leases (Singer et al, 2017).

A simple summary of the new guidelines is, 1) All leasing standards must be effectively reflected on the balance sheet, 2) All companies must put the rules into effect staring after December 15, 2018, 3) All companies that have leases must evaluate their lease data to ensure that they compare them as from 2018 FASB (2016). In order to understand the scope of the accounting standard change that the ASU 2016-02 seeks to implement, companies need to consider the type of lease accounting that the new standards are shifting to.

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1.2 Elements featured in Amazon.com Inc.'s current information for its leases.

The ASU 2016- 02 brings with it significant changes to financial statements and processes. This paper looks at Amazon.com Inc. to seek to understand how new standards can be used to address the inconsistencies that arise in the prior guidelines on the reporting of leases. To analyze the change in the reporting of leases, we consider three elements: contingent rent, minimum rent expense, and the deferred rent liability.

After researching Amazon.com Inc., results indicate that the company uses contingent rent while dealing with some of its leases. Contingent rent is the part of a lease payment that is not fixed but is instead based on the amount of the future value of a certain factor that changes as time passes, for example, future interest rates or future rate of sales. Contingent rent requires professionals who determine it to be experienced, prepared, and talented because of its predictive nature (Kancharla & Hegde, 2016). Contingent rent is also affected by the future increase or decrease in profitability of Amazon.com Inc. as well as inflation and deflation of currency. Before adopting contingent rent, companies need to consider the fact that a contingent rental agreement is built on the basis of what a lessee uses the leased asset for, price changes in an economy, as well as the financial and operational performance of the lessee. The contingent rent that Amazon.com Inc. accounts for in its balance sheets which causes an increase on the side of liabilities and needs a lot of attention. Amazon.com Inc. is extremely successful, and this will influence the future sales projections, acquisitions, and profit turn over, which will affect its contingent rent.

Minimum rent expense is the second element to be considered in the current information reported by Amazon. Minimum rent expense is defined as the least amount that a lessee expects to pay for the duration of a lease. The minimum lease payments give value to capital lease after being discounted. Amazon.com Inc. reported a minimum rent expense on a straight-line basis over the terms of its leases after including its costs of occupancy with the adjustment of cash rent accrued as deferred rent in its consolidated balance sheets (NASDAQ, 2018). Another element to consider is Amazon's deferred rent. This is a rent-free period that a lessee is given by the lessor. Amazon.com Inc. records tenant improvement allowances and rent holidays as deferred rent liabilities within amassed liabilities.

1.3 Impact of the new guidelines on the reporting of Amazon.com Inc.'s leases

The main impact that the new guidelines have had on the recording of Amazon.com leases is due to the change in the classification of capital and operating leases. Amazon.com Inc. now has to account for right to use assets on a separate side of the balance sheet from interest on the lease liability. When it comes to capital leases, Amazon will now have to classify its repayments of the principal of a lease in financing activities, and repayments of interest of on the lease liability will be recorded as operating activities (FASB, 2016). For operating leases, Amazon.com Inc. will have to calculate a single total lease cost that will be allocated over the total length of the lease on a straight-line basis, and all cash payments will be recorded in the statement of cash flows as operating activities (Accounting tools, 2017). Amazon will also be required to disclose information about varying lease payments and whether they aim to renew or terminate leases upon the end of the current terms of the leases.

The new GAAP guidelines bring with them several challenges to Amazon as it strives to implement them. These challenges include: Amazon needs to reorganize all its lease data. Amazon does not have its lease information centralized in one place, and it will be difficult to find accurate data that accounts for all the leases that the company has. Another problem Amazon faces is the need to get the right systems in place. Like most companies, Amazon uses spreadsheets to account for its leases. The new guidelines will make using this method to account for leases and move them into the balance sheet too difficult and time-consuming. Amazon, therefore, needs to set up software for lease calculation in order to effectively adopt the new standards (Kancharla & Hegde, 2016).

Amazon also faces the problem of improving its lease accounting process. Amazon, like most companies, has not paid too much attention to the monitoring and requisition process of its leases. This needs to change as leases will now be accounted for in its balance sheets. Amazon has to begin scrutinizing the leasing processes it goes through ad remove any inconsistencies that were in the process. As the new software and protocols are put in place, Amazon needs to educate its staff on how to use it. Amazon will need to teach its real estate manager to keep all lease information according to the new guidelines so that it can be forwarded to the finance team (Kancharla & Hegde, 2016). The finance department, in turn, has to be educated on how to account for the leases in the company's balance sheets, and they need to be taught how to use the new software that will help them keep an updated information system on leases.

The new guidelines do not bring all bad news; however, the need to centralize and analyze data brings with it new opportunities for amazon. Amazon can use the information obtained about its leases to negotiate better leasing terms in the future, analyze the data and come up with consistent standards for operating its leases and make better management decisions on leases (Harms 2020). For amazon to make a successful transition into the new guidelines, it needs to make changes. The company needs to select a team to prepare it for the transition. The team should include accounting staff, financial officers, and professionals that deal with Amazon.com Inc. real estate who will help the company to design and implement processing systems for the lease information and who will set up new leasing accounting standards.

1.4 Impact of ASU 2016-02 on Amazon.com Inc.'s financial ratios

While the previous GAAP only recognized capital leases on the lessee's balance sheets, the ASU 2016-02 requires lessees to account for both capital and operating leases in companies' financial statements. This will result in improved lessee disclosure and will make it easier for users of financial statements to study the cash flows that come from leases. Amazon has projected the potential effects of adjusting its financial statement to capitalize operating leases under the ASU 2016-02.

- Debt to equity ratio- Amazon's debt to equity ratio was 0.39, but after adjusting its financial statement to account for leases under the new guidelines, it dropped to 0.37 (NASDAQ, 2018).
- Current ratio- Amazon's current ratio barely shifted after the adjustment. It went from 1.098 before the adjustments on leases to 1.097 after.

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- Return of equity- The companies return on equity ratio rose from 12.29 to 18.67 after adjusting for ASU 2016-02.
- Return of assets- After adjusting for the new GAAP guidelines, this ration rose from 2.82 to 5.14 (NASDAQ, 2018).

The new GAAP guidelines on the treatment of leases on balance sheets and income statements provide a clearer view of Amazon's financial position.

1.5 The impact of the new guidelines to the recommendations of stock analysts for Amazon.com Inc.

The changes brought about by the updated accounting standard change the overall value of a company. Corporate analysts mainly pay attention to the composition of the balance sheet and the alignment of the income statement of a company with its balance sheet. They analyze the value of the debts and equity that the company has in order to determine the value of a company. After adjusting for the changes in accounting for leases, Amazon.com Inc. has been found to have a high stock value, and stock analysts recommend a strong buy.

In conclusion, the new GAAP guidelines on the treatment of leases has corrected the problems that were criticized in the previous guidelines. The ASU 2016- 02 Leases have brought major improvement in the way leases are accounted for and will bring with it clear improvements in the estimation of the financial standing of companies. Though it will take some time and money to effectively adopt the guidelines, they will be beneficial to the companies in the long run.

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