ACCOUNTING OF LEASE CONTRACTS ACCORDING TO IAS 17 "LEASING CONTRACTS"

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Abstract

Leasing is a medium term (movable leasing) or long term (real estate leasing) financing technique, as an alternative to indebtedness, allowing a firm to exploit goods without being forced to rely on loans or own capitals. The specialized financial institution, as owner of the goods (lessor), will assign the goods to a user (lessee) based on a firm request and against payment of a rent, which can include, as the case may be: amortization of the asset; remuneration of the invested capital (based on commission); risk premium due to the fact that the financial institution (lessor) nears the entire financing; administrative expenses. This article presents the registration of the leasing in accounting, according to IAS 17, both from the point of view of the lessor, and from that of the lessee.

Keywords: lessor, lessee, financial leasing, interest rate, residual value, amortization

JEL Classification: M10, M41, M48

Introduction

Leasing operations constituted one of the controversy subjects in the accounting theory, finally leading to the imposition of the principle of prevalence of *substance over form*.

The controversy was disputed between the legal (patrimonial) approach and the economic one of the accounting balance. According to the legal theory, the balance shows the legal status of the company at a given time – i.e. the goods in the possession of the company, debt rights, as well as their relevant obligations. However, along with the evolution of the economic activity, in the business practice there appeared certain transactions (leasing operations, sales with property reserve clause, sales with redemption clause, debt factoring), which, although are circumscribed (sometimes) into a traditional legal figure, they have a totally different economic content than their legal form shows. And if such operations would be accounted according to their legal form and not their economic substance, the information supplied by the financial situations would no longer be relevant, and accounting would not achieve its fundamental target of presenting a true image of the *economic reality*.

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Where the *lease contracts* are concerned, these are agreements by which the *lessor* – legal owner of the goods, assigns to the *lessee*, for a determined period of time, the right to use an asset, against one payment or a series of payments.

In certain circumstances, leasing operations place the lessee in the same economic position it would have had if it had chosen an external loan aimed at buying the goods forming the subject of the lease contract. We say only *economic*, not also *legal*, since from the legal point of view there is no similitude, the right of ownership over the goods not being transferred to the user but remaining with the lessor. This differentiation between the *legal* nature and the *economic* nature of leasing lead to numerous discussions, not being known whether, on drawing up the financial situations, there should be taken into consideration the obvious financial substance of certain operations or their legal nature. Otherwise told, if the leased goods should be recorded in lessee's balance although it does not hold the right of ownership over such goods.

Accounting Instrumentation of Lease Contracts

1. Financial leasing in lessee's financial statements

On the **contract commencement date**, the lessee will account an **asset** and a **liability** assessed at the **true value** of the goods; or, if lower, the **updated value of the minimum leasing payments** determined on the initiation date of the contract.

The costs incurred by the lessee, which can be attributed directly to the contract (such as costs related to negotiations) are not recorded in the profit and loss account, but capitalized by the increase of the value of the leased goods.

Amortization of the goods will be recorded by the lessee, as it is the one consuming the majority of the economic benefits produced by the asset which forms the subject of the contract. Under conditions in which there is the reasonable certainty that the right of ownership will be transferred to the lessee at the end of the contract, then there can be established a useful life duration exceeding the duration of the contract.

Example: Commercial Company X and Commercial Company Y enter into a lease contract on January 1, 2005, the subject being an industrial piece of equipment.

The main contract data are:

- *Acquisition cost from the supplier*: RON 11,000,000.
- *Leasing period*: 5 years.
- *Initial payment*
- *Leasing installments*: 5 annual installments amounting to RON 3,000,000 each, paid on December 31 of each year.
- *Option price*: the option to buy may be exercised at the end of the contract, at the value of RON 500,000.
- *Economic life duration of the piece of equipment*: 6 months.
- *Residual value*: RON 1,500,000.

- *Residual value warranted by the lessee*: 20%.

To enter into the contract, the lessee made expenses with economic-legal counseling in view of the negotiation amounting to RON 10,000, wich were invoiced on December 22, 2004.

Solution:

Stage 1. Contract rating:

The above contract is a financial leasing contract because it observes at least two or the criteria requested by IAS 17:

1) The contract duration (5 years) covers most of the economic life duration of the piece of equipment (6 years), i.e. approximately 83%.

2) The option price (RON 500,000) is sufficiently advantageous in comparison with the residual value (RON 1,500,000) – approximately 33% of the residual value – so that there is the reasonable certainty that the piece of equipment will be bought by the lessee at the end of the contract.

Stage 2. Calculation of the implicit interest rate:

$$11.000.000 = 2.000.000 + \sum_{t=1}^{5} \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} + \frac{1.000.000}{(1+i)^5}$$

where,

i = rate of actual/implicit interest of the contract;

t = number of years.

From the calculation results i = 22.71615 %.

Stage 3. Calculation of the updated values of minimum leasing payments (VP(PML))

$$\text{VP(PML)} = 2.000.000 + \sum_{t=1}^{5} \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} = 10.640.672 \text{ RON}$$

The updated value of the minimum leasing payments (RON 10,640,672) is lower than the fair value of the piece of equipment (RON 11,000,000).

Stage 4. Elaboration of the reimbursement table

Date	Principal to be reimbursed at the beginning of the financial service	Payments	Interest	Reimbursed principal	Principal left to be reimbursed at the end of the financial service
(1)	(2)	(3)	(4) = (2) x 22.71615%	(5) = (3) – (4)	(6) = (2) – (5)
01.01.2005	10,640,672	2,000,000	0	2,000,000	8,640,672
31.12.2005	8,640,672	3,000,000	1,962,828	1,037,172	7,603,500
31.12.2006	7,603,500	3,000,000	1,727,222	1,272,778	6,330,722

31.12.2007	6,330,722	3,000,000	1,438,096	1,561,904	4,768,819
31.12.2008	4,678,819	3,000,000	1,083,292	1,916,708	2,852,111
31.12.2009	2,852,111	3,000,500	647,889	2,852,111	0

Stage 5. Recording of the lease contract
On **22.12.2004** the expenses related to contract negotiation are recorded

231 "Immobilization under way" = 401 "Suppliers" 10.000

On **01.01.2005** (date of commencement of the leasing period) there will be recorded:

- reception of the goods, at the level of updated minimum leasing payments:

"Industrial equipment" = "Other long-term loans 10,640,672
Lease contracts"

- capitalization of expenses related to negotiations:

"Industrial equipment" = "Immobilizations under way" 10,000

- accounting of the initial payment;

"Other long-term loans" = "Checking accounts with banks" 2,000,000
Lease contracts"

On **31.12.2005** there will be recorded:

- payment of the first leasing installment:

% = "Checking accounts with banks" 3,000,000
"Other long-term loans.
Lease contracts" 1,037,172
"Expenses related to interest" 1,962,828

- recording of the amortization of the goods:

Amortization of the goods in linear regime:
- useful life duration: 6 years;
- residual value (assessed at the end of the useful life duration): RON 0.

Amortizable value: 10,640,672 + 10,000 – 0 = lei 10,650,672
Annual amortization: 10,650,672 / 6 = RON 1,775,112/year
"Amortization expenses" = "Corporal immobilizations amortization" 1,775,112
Corporal immobilization"

The records at the end of 2005 are repeated each year until the end of the contract.

2. Financial leasing in lessee's financial statements

At the commencement of the contract, the lessee will record a **debt** (granted loan) assessed at an equal value with a **net investment in the lease**, representing the **gross investment in the lease** updated to the implicit interest rate. The **gross**

investment represents the amount between the minimum leasing payments and any unguaranteed residual value. The difference between the gross investment and its updated value represents the **unearned finance income.**

Practically the debt will be recorded at the fair value of the goods (represented, usually, by the cost of acquisition of the goods from the supplier) plus other costs which are directly related with the conclusion of the contract (such as: negotiation costs). Consequently the expenses which can be directly related to the contract are not recorded in the profit and loss account but are capitalized by increasing the value of the debt.

The lessor no longer presents the goods in financial leasing in its balance since it no longer has control over such goods (no longer holds the majority of advantages and risks related to the property) and no longer records the amortization thereof.

The unearned finance income will be allotted/recognized along the leasing period so as to reflect a constant interest rate over the net investment.

Example: We will solve below the previous example from lessor's point of view.

Solution:

Stage 1. Contract rating:

The contract the data of which were stated is a financial leased contract from the same considerations presented above.

Stage 2. Calculation of the implicit interest rate:

The implicit interest rate of the contract (calculated above): i = 22.71615 %.

Stage 3. Calculation of the net investment in the lease (INL):

INL = Updated gross investment in the lease (VP(IBL))

$$\mathrm{VP(IBL)} = 2.000.000 + \sum_{t=1}^{5} \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} + 1.000.000 = 11.000.000 \text{ RON}$$

Stage 4. Calculation of the unearned fiancé income and constant remuneration rate of the net investment (r)

VFN = IBL –VP(IBL) = IBL - INL

IBL = 2,000,000 + 5 x 3,000,000 + 500,000 + 1,000,000 = RON 18,500,000

VFN = 18,500,000 – 11,000,000 = RON 7,500,000

The unearned finance income represents the remuneration of the net investment, the investment unrecovered by the minimum leasing payments. Consequently, in order to allot the financial income related to the contract along the leasing period, there will be calculated the interest rate required to update the minimum leasing payments so that it reimburses the presented value of the net investment.

$$11.000.000 = 2.000.000 + \sum_{t=1}^{5} \frac{3.000.000}{(1+r)^t} + \frac{500.000}{(1+r)^5}$$

From calculations there results r = 20.852815%

Stage 5. Elaboration of the reimbursement and allotment of the financial income table

Date	Principal to be reimbursed at the beginning of the financial service	Payments	Interest	Reimbursed principal	Principal left to be reimbursed at the end of the financial service
(1)	(2)	(3)	(4) = (2) x 22.71615%	(5) = (3) – (4)	(6) = (2) – (5)
01.01.2005	11,000,000	2,000,000	0	2,000,000	9,000,000
31.12.2005	9,000,000	3,000,000	1,876,753	1,123,247	7,876,753
31.12.2006	7,876,753	3,000,000	1,642,525	1,357,475	6,519,278
31.12.2007	6,519,278	3,000,000	1,359,453	1,640,547	4,878,731
31.12.2008	4,878,731	3,000,000	1,017,353	1,982,647	2,896,085
31.12.2009	2,896,085	3,000,500	603,915	2,896,085	0

Stage 6. Recording of the lease contract

On **01.01.2005** there will be recorded:

- assignment of the goods at the level of the net investment in the lease equal to the fair value of the goods on the contract commencement date:

"Other long-term debts" = "Industrial equipment" 11,000,000
Lease contracts"

- collection of the initial payment

"Checking accounts with banks" = "Long-term debts. 2,000,000
Lease contracts"

On **31.12.2005** there will be recorded the collection of the first leasing installment:

"Checking accounts with banks"	=	*%*	*1,000,000*
"Other long-term debts.			
		Lease contracts"	*110,884*
		"Income from interest"	*889,176*

Amortization of the goods: not recorded, the goods being taken out if lessor's assets.

The records at the end of 2005 are repeated each year until the end of the leasing period with the amounts in the reimbursement table.

3. Operational leasing in lessee's financial statements

The goods taken in leasing are not recognized in the balance since the lessee does not hold control over them. The leasing payments are recognized as an **expense** in the profit and loss account over the duration of the contract.

Example. Commercial Company X SRL and Commercial Company Y SRL enter into a lease contract on January 1, 2005, having as subject one Minolta type EC400 copier.

The main contract data are:

- *Acquisition cost from the supplier*: RON 11,000,000
- *Leasing period*: 4 years.
- *Leasing installments*: 4 annual installments amounting to RON 1,000,000 each, payable on December 31 of each year.
- *Option price*: the option to buy may be exercised at the end of the contract, at the value of RON 10,500,000.
- *Residual value of the piece of equipment at the end of the contract:* RON 10,700,000.
- Economic life duration of the piece of equipment: 10 years.

Solution:

Stage 1. Contract rating:

The above contract is an operational lease contract since it does not observe any of the criteria requested by IAS 17:

- the contract does not provide transfer of the ownership right at the end of the leasing period;
- the option to buy the piece of equipment cannot be exercised at a sufficiently advantageous price (10,500,000 as compared to 10,700,000) in order to exist a reasonable certainty tat the piece of equipment will be bought at the end of the contract;
- the contract does not cover most of the economic life duration of the piece of equipment (4 years as compared to 10 years);
- the updated value of the minimum payments on contract commencement date is not equal or greater than the fair value of the piece of equipment on that date:

$$11.000.000 >>> \sum_{t=1}^{4} \frac{1.000.000}{(1+i)^t}$$

- the asset forming the subject of the contract does not have a specific nature, so only the lessee can use it without significant alterations.

Stage 2. Elaboration of the reimbursement table

Date	Payments
(1)	(2)
2005	1,000,000
2006	1,000,000
2007	1,000,000
2008	1,000,000

Stage 3. Accounting of the lease contract

On **01.01.2005** there will not be recorded the receipt of the piece of equipment in the lessee's balance as it does not have control over the resource (does not have majority of advantages and risks related to the piece of equipment):

On **31.12.2005** there will be recorded payment of the first leasing installment:

"Royalty expenses" = "Checking accounts" 1,000,000

Amortization of the piece of equipment: not recorded by the lessee, not recognizing the piece of equipment in the balance.

4. Operational leasing in lessor's financial statements

The piece of equipment forming the subject of the lease contract is shown in the balance according to its nature. The leasing payments are recognized as **income** into the profit and loss account for the duration of the contract.

Example. We take into consideration the same issue presented above from the point of view of the lessor.

Solution:

Stage 1. Contract rating:

The above contract is an operational lease contract as it does not observe any of the criteria requested by IAS 17, as shown in the above example.

Stage 2. Elaboration of the reimbursement table

Date	Collections
(1)	(2)
2005	1,000,000
2006	1,000,000
2007	1,000,000
2008	1,000,000

Stage 3. Accounting of the lease contract

On **01.01.2005** the assignment of the piece of equipment there will not be recorded as the lessor continues to have control over the resource, continuing to show it in its balance.

On **31.12.2005** there will be recorded:

- collection of the first leasing installment:

"Checking accounts with banks" = "Income from royalties" 1,000,000

Amortization of the piece of equipment is recorded by the lessor, it continuing to recognize the piece of equipment in the balance.

Amortization of the piece of equipment in linear regime:

- useful life duration: 10 years;
- residual value: RON 1,000,000.

Amortizable value: 11,000,000 – 1,000,000 = lei 10,000,000

Annual amortization: 10,000,000 / 10 = RON 1,000,000/year

"Amortization expenses = "Corporal immobilizations amortization" 1,000,000
corporal immobilizations"

Conclusions

The impact if the leasing operation on the accounting statements of the lessee company differs according to the type of leasing contracted.

Thus, in the case of operational leasing, modifications are not produced al balance level, the operation being recorded outside the balance, as a consequence the degree of indebtedness of the company remains unchanged, not altering company's capacity to contract debts, this representing an advantage in case of attracting new investors, since this type of leasing determines a fictitious increase of company's profitability. The lease paid by the lessee is recorded as an exploitation expense in its profit and loss account. Considering its outside of balance recording, the financial analysts may overlook such capitals invested in the company, similar to debts, the increase of the economic profitability resulting from the reporting of the exploitation profit.

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