The 14th Economic International Conference: Strategies and Development Policies of Territories: International, Country, Region, City, Location Challenges | May 10-11, 2018 | Stefan cel Mare University of Suceava, Romania

Strategies and Development Policies of Territories: International, Country, Region, City, Location Challenges

IFRS 16 - Challenges and Opportunities in Adopting and Applying the New Standard Regarding Leases

Veronica GROSU, Elena HLACIUC

<https://doi.org/10.18662/lumproc.85>

How to cite: Grosu, V., / Hlaciuc, E. (2018). IFRS 16 - Challenges and Opportunities in Adopting and Applying the New Standard Regarding Leases. In C. Năstase (ed.), *The 14th Economic International Conference: Strategies and Development Policies of Territories: International, Country, Region, City, Location Challenges | May 10-11, 2018 | Stefan cel Mare University of Suceava, Romania* (pp. 345-354). Iasi, Romania: LUMEN Proceedings.
<https://doi.org/10.18662/lumproc.85>

The 14th Economic International Conference: *Strategies and Development Policies of Territories: International, Country, Region, City, Location Challenges* | May 10-11, 2018 | Stefan cel Mare University of Suceava, Romania

IFRS 16 - Challenges and Opportunities in Adopting and Applying the New Standard Regarding Leases

Veronica GROSU¹, Elena HLACIUC^{2*}

Abstract

The purpose of the paper is to study the evolution of the global, European and national leasing market, but first of all to take into account the changes introduced by the new IFRS 16. Thus, it was found that although the Romanian leasing market follows the same trend as the European leasing market, Romania prove to be more susceptible to negative changes in the economy. Moreover, economically developed countries account the highest part of the financing through leasing. This demonstrates that leasing cannot evolve without being closely linked to the economic development of the country in which it operates as product.

Keywords:

IFR 16, LAS 17, leasing contracts, leasing markets.

Introduction

Leasing is, from all points of view, a market economy product that has been imposed as a financing alternative because of the speed of physical and moral degradation of the technological equipment. In the context of permanent renewal of the production means, new funding sources are searched to allow the use of modern technology at optimum costs. The use of the leasing system has shown that not the legal ownership of a good

¹ Professor PhD, Stefan cel Mare University of Suceava, Suceava, Romania, douruveronica@yahoo.it.

² Professor PhD, Stefan cel Mare University of Suceava, Suceava, Romania, elenahlaciuc@gmail.com.

<https://doi.org/10.18662/lumproc.85>

Corresponding Author: Elena HLACIUC

Selection and peer-review under responsibility of the Organizing Committee of the conference

This is an Open Access article distributed under the terms of the Creative Commons Attribution-NonCommercial 4.0 Unported License, permitting all non-commercial use, distribution, and reproduction in any medium, provided the original work is properly cited

creates value but the proper use of it. Over the time, it has evolved differently from one country to another, from one continent to another, so we consider interesting to study the evolution of leasing worldwide and on the European continent to see if our country has the same evolution trend, as well as which is Romania's position towards the main countries opting for financing through leasing. Moreover, will be highlighted some evolution trends and will be identified the factors limiting the expansion of this financing source at national level (6).

A major concern in the current period is to reduce the differences between accounting principles used in major capital markets around the world, because the scientific literature considers that domestic regulations of different countries are a barrier to extending the leasing system.

The new IFRS 16 Standard was published in January 2016 by the International Accounting Standards Board, therefore this standard, undoubtedly, began a new era of accounting principles in terms of leasing contracts, at least from the lessees point of view. Under the previous IAS 17, the lessee had to make a clear distinction between financial and operating leasing contracts, but defining the difference between these two types of leasing has created many of the problematic issues associated with that standard [7, p. 3]. Under IAS 17, financial leasing contracts were included in the balance sheet, but operating leasing contracts could only be recorded as expenses in the profit and loss account [2, p. 4]. Instead, the new IFRS 16 regulations describe that there is no longer any need to classify financial and operational leases, meaning that from the accounting perspective, each lease is treated as a finance lease. In fact, this means that all tenant's lease agreements must be recorded in the financial statements. However, if the company has many operating leases, this could have a major impact on the company's financial statements.

This IFRS allows companies to record some of their leased assets and the payments they include as expenses. This, essentially, means that the leasing does not affect in any way the performance of the company's balance sheet.

Literature review

Regarding the accounting of corporate leasing activities, this represents the concern for academics and practitioners, being examined and debated for over 30 years. Both international bodies, IASB and FASB are developing standards to modify the financial statements for operating leases that are currently reported out of the balance sheet. In the light of these

proposals, we analyze the existing literature to anticipate, better, the possible effects of any changes. We analyze the international studies to understand why firms engage in leasing contracts and how information about these arrangements has an impact on users. First, we take into account the studies that directly examine leasing contracts. Other studies, however, suggest that firms use leases to manage costs and for capital savings Samuelson (1996) [8]; Sicchiero (2010) [9]; Fabi (2016) [4]. In general, research reports show that creditors, credit rating agencies and other capital market participants understands, sufficiently, the leasing contracts out of the balance sheet and take them into account for making decisions Albanese & Zeroli (2011) [1], Cerbioni, Cinquini & Sostero (2011) [3], Taylor (2011) [10].

Leasing is a very important source of funding that is widely used. It allows entities, from small businesses to multinationals, to acquire the right to use real estate properties without making large initial expenses.

Regarding the treatment of leasing from the accounting point of view, the national literature is relatively limited and is not updated. Authors such as Tiță-Niculescu (2006) [11], in the paper *Leasing*, Florescu and Rotaru (2013) [5] in the paper *Leasing Contract* or Barna (2010) (4) in *Leasing Operation in International Trade*, treat the leasing contract from a legal point of view. Leasing is a contract, through which a company acquires the use of a particular asset for a certain period of time as an alternative to the acquisition of the same asset (Regalli, Tagliavini 2004) (5).

An important work was published in 1985 by Voiculescu & Coraș [12], entitled *Leasing*, which defines leasing as "a form of renting machinery, equipment, transport means and other assets to enterprises that generally do not have sufficient funds owned or borrowed, nor traditional bank loans, by the financial companies that buy them from producers and leases them for a certain period, with payment and usage terms clearly specified in a contract that constitutes the legal support of the action."

In the international literature, there have been, over the time, special concerns to demonstrate the advantageous nature of leasing compared to other forms of financing, but the results are questionable and differ depending on the object which is financed. As a result, comparisons of bank credit for investment and leasing in the agricultural sector were imposed, because the goods financed, for example, tractors and agricultural machinery, are the subject to an increased physical and moral depreciation. Moreover, the financing structure of leasing equipment in 2015 shows that agricultural equipment occupies the main segment.

When making a financing decision, the entrepreneur is interested not only in the economic efficiency of a financing source, but also on the

household aspect. The financing of an investment must be productive and safe and at the same time cost-effective.

It is, therefore, appropriate to present in this paper some accounting aspects related to leasing, such as: the recognition of the lease object in accounting, its depreciation, and the regulation of leasing contracts in accordance with IAS and US GAAP international standards.

The effect of leasing contracts on the financial statements and financial indicators

Tangible fixed assets owned under a lease contract are recorded in the accounting depending on the provisions of the contract between the parties and the legislation in force. According to OMFP 1802/2014 at the beginning of the leasing contract, the leasing contract is classified into: financial leasing and operational leasing.

Romanian legislation recognizes as a financial lease the contract that fulfills at least one of the following conditions [17]:

Figure 1 Conditions for recognition as financial leasing

Source: Adapted based on OMFP 1802/2014, art. 213(2)

Economic entities that use leasing as a financing instrument have the obligation to register operations in the accounting and balance sheet. Besides the effects on financial statements, the lease contract is included in the calculation of certain financial indicators.

NO.	Indicators	Implications
1	Indebtedness level	Interest costs are fully deductible if the debt ratio is less than or equal to 3. Therefore, interest on lease rates, as well as property insurance costs and the lease management are recorded as costs, being deductible while calculating the taxable profit.
2	Return on assets	The indicator measures the effectiveness of the total asset use, called advanced capital, in terms of the profit obtained, and is calculated as the ratio between the net result and the balance sheet asset and shows how many RON brings in the form of profit, a RON invested in assets.
3	Return on capital employed	The indicator measures the return of the firm long-term liabilities, representing long-term debt and equity. A lower return on capital than the cost of the attracted capital is an unfavorable situation for shareholders, because it will generate a lower return than its cost.
4	Indicator regarding interest covering	It is an economic-financial risk indicator, which determines how many times, the economic entity can repay the interest debt. It is calculated as the ratio between the amount of the profit before the interest and the profit tax payment and the interest expense; therefore the lower the value of this indicator is, the more risky is the financial position of the company.
5	Net margin of the profit	The net profit margin is calculated as a percentage between the net result of the exercise and the net turnover and a result less than 1 indicates an unstable situation, between 1% and 15% indicates a stable situation and a result greater than 15 % denotes a volatile situation.
6	Assets speed rate	Increasing the rotation speed of assets represents the increase of their liquidity, meaning a decrease of the recovery time in cash. Therefore, the increase in the value of the fixed assets leads to a reduction in the rotation speed of the assets.
7	Rate of general liquidity	Liquidity involves the existence of sufficient cash assets to pay the company's debts at maturity, including interest for the contracted loans and to cover the unforeseen cash needs.

The values of the economic and financial profitability indicators are of particular importance in the analysis of the projects submitted for funding through the Cohesion Funds, Structural Funds, etc. The European Commission recommends that the rate of financial return to be below 5% to justify the monetary investment, while the rate of economic return should be over 5.5% to demonstrate the social benefits of the project.

Once the economic aspects of the leasing transaction have been clarified, we must consider their accounting treatment. Before applying to the methods that are currently in force and which are the subject of the new IFRS 16, we will summarize the basic perspectives underlying the main accounting guidelines for leases.

The International Financial Reporting Standard number 16 shares the same objective regarding defining the correct valuation and representation principles in the financial reporting of all leases, but comparing with its predecessor IAS 17 [18] pay more attention to the effects that leases produces on the financial performance and cash flow of the parties involved in the contract.

The cases of excluding IFRS 16 application are, apparently, more numerous regarding IAS 17, namely [13, 15-16]:

a) IAS 17 highlights two instances, namely, where its application is totally exempt, such as the exploitation and extraction of mineral resources, oil, natural gas and other similar non-renewable resources, and where the standard is normally applied, but is derogated from its assessment criteria to refer to more specific criteria, dictated by other standards, proper to that categories of goods;

b) IFRS 16 unifies all of these assumptions, stating that it should not apply, to:

- Exploitation of mineral, oil, natural gas and similar non-renewable resources;

- Biological assets that fall under the IAS 41 domain of application - Agriculture;

- Service concession contracts that fall under the domain of application of the interpretative document of IFRIC 12 - Service and concession agreements;

- Licenses and intellectual property rights granted by the lessor and falling within the application domain of IFRS 15 - Revenue from contracts with customers;

- Rights held by a tenant through a re-licensing agreement within the application domain of IAS 38 - Intangible Assets.

The major change in the application domain of the two standards lies in introducing that option for the lessee, who may, if he considers it necessary, opt for the application or not of IFRS 16. [18]

These alternatives have been introduced because many tenants/users/lessee have expressed their dissatisfaction regarding that the application of the new rules for leases, of very short duration, or of low value, would have required a lot of time and costs without an adequate benefit from the effectiveness and quality of financial reporting information point of view. **(1)**

If the tenant/lessee decides to make use of these options, he will have to proceed so as to mention the costs of the leased rate payments on a linear basis, throughout the contract period, as in the case of an operating lease, in accordance with the equity principle.

The breakdown on a linear basis of the cost is not the most appropriate for certain specific situations, the lessee may apply another systematic, more representative criterion for the breakdown in time, of the benefits deriving from the contract.

If during the contract a change or any change in duration occurs, which leads to the fact that we no longer classify it as a short-term leasing contract, the tenant/user/lessee will have to do so, considering it as a new operation and to continue account it in accordance with the methods set out in IFRS 16. **(2)**

With respect to the classification of leasing contracts, IFRS 16 comes in the same way as IAS 17 **(3)**, but with a large difference: in fact, the lessee's financial statements lays down a unique model for recognizing the lease to be recorded in accounting, without making any distinction between operating leasing and financial leasing.

In the lessor's balance sheet, the distinction between operating leasing and financial leasing is maintained and does not differ from IAS 17. The leasing contract is classified as a finance leasing, when it substantially transfers all the risks and benefits derived from the asset use which is the subject of the contract, on the property. Instead, it is classified as operational when the risks and benefits of ownership on the assets are not transferred and remain with the lessor [14].

Determinant factors according to the new standard

Leasing is a contract or part of it that gives the right to use an asset for a period of time in exchange for a fee.

An asset can be defined as "identified" when it is explicitly or implicitly identified in the contract, the asset is physically distinct from other assets and the supplier does not have the substantial rights to replace it.

A vendor has the right to change the good when:

a) has the ability to change the good without the client being able to prevent it, and

b) will have an economic benefit from exercising this right.

The right to use for a period of time occurs when the customer has the right to obtain economic benefits by using the asset for the entire period. Also, the client has the right to determine how and for what purpose the good is used. It has the right to use the asset for the entire period of the right of use, without the supplier having the right to change the operating instructions.

Financial leasing versus operational leasing

Leasing is an alternative to long-term loan financing and with secure guarantees. So, it causes the emergence of two problems that need to be resolved, as the indebtedness and the cost of financing those operations. Thus, leasing, as a source of funding, is classified as borrowed capital.

The leasing contract confirms that the lessee has the right to use the asset, but instead he has to pay a series of regular rates to the lessor, the owner of the asset. The lessor may be both, the asset manufacturer or an independent leasing company. If the lessor is represented by an independent leasing company, it involves buying the asset from a manufacturer. In this way, the lessor makes available to the lessee the purchased asset and the lease begins to generate effects.

The use of an asset can be done through a lease contract. As long as the lessee has the right to acquire the asset, the purchase and lease of the asset are represented by two different financial arrangements.

Conclusions

Regarding the financial and operational leasing, we consider that the financial leasing is the most advantageous, because at the end of the contract

the rented property can be bought and thus, enters into the lessee's property for a residual value. On the other hand, the object of the operating leasing cannot be purchased. Operational leasing is more rigorous than the financial leasing. The client who is seeking an operating leasing must establish from the beginning the clear structure of the contract. The lessee must clearly indicate the number of kilometers covered during the lease, the repairs to be made and the exact term of the contract.

As well, the companies in continuous development will always resort to financial leasing because they want to have no limit on the kilometers traveled but also to change the car with a new model. On the other hand, operational leasing offers the possibility to use a new vehicle through renting and the clients of such a leasing are companies that have a standardized management based on budgets as corporations or large companies. In addition to renting, the contract rates may include fuel card services, tires or other costs.

Notes

- (1) Paragraph BC84, Basis for Conclusions on IFRS 16 Leases
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F269%2FIFRS%2016%20Leases_Basis%20for%20Conclusions.pdf,
- (2) Paragraph 6-7, IFRS 16 Leases
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F269%2FIFRS%2016%20Leases_Standard.pdf.
- (3) Paragraph 9, IFRS 16 Leases
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F269%2FIFRS%2016%20Leases_Standard.pdf.
- (4) Barna N., Operațiunile de leasing în contractual internațional
<http://www.tipomoldova.ro/books/Operatiunile%20de%20leasing.pdf>
- (5) Regalli M, Tagliavini G, A new approach for estimating the tax advantage of leasing, available on
<https://www.emeraldinsight.com/doi/abs/10.1108/01409170410784149>

References

- [1] Albanese M., Zeroli A. Leasing e Factoring – quarta edizione. Milano: Edizioni FAG; 2011: 180-182
- [2] Beckman J. K. Accounting and Managment Info Systems, University of Rhode Island, Kingston, Rhode Island, USAFASB and IASB diverging perspectives on the new lessee accounting: Implications for international managerial

- decision-making; 2015. Available online at:
<https://www.emeraldinsight.com/doi/abs/10.1108/IJMF-08-2015-0161>.
- [3] Cerbioni F. Cinquini L. Sostero U. Contabilità e bilancio – Terza edizione. Milano: McGraw-Hill; 2011.
- [4] Fabi T. Il nuovo IFRS 16 sui contratti di leasing in “Il fisco” 9/2016; 2016: 866-870.
- [5] Florescu D., Rotaru M. Contractul de leasing. Editura Universul Juridic; 2013.
- [6] Gheorghiu Gh. Vrabie B. Forme ale contractului de leasing. Revista de drept commercial, Nr. 3/2006.
- [7] Knubley R. Proposed changes to lease accounting. Journal of Property Investment & Finance, 28 (5); 2010. pp. 322-327
- [8] Samuelson R.A. The Concept of Assets in Accounting Theory, Accounting Horizons, 3/1996. p. 147.
- [9] Sicchiero G. Fondamenti di tecnica contrattuale, CEDAM; 2010: 22.
- [10] Taylor J. The history of leasing. Finance and Business Institute; 2011.
- [11] Tița-Nicolescu G. Leasing. București: Editura C.H. Beck; 2006.
- [12] Voiculescu D. Coraș M. Leasing. București: Editura Științifică și Enciclopedică; 1985.
- [13] Project Summary and Feedback Statement IFRS 16 Leases
http://www.ifrs.org/Current-Projects/IASBProjects/Leases/Documents/IFRS_16_project-summary.pdf.
- [14] Guida al Diritto, Il Sole 24 Ore ,
http://www.diritto24.ilsole24ore.com/guidaAlDiritto/codici/codiceCivile/articolo/29_19/art-2423-bis-principi-di-redazione-del-bilancio.html?refresh_ce=1.
- [15] IASB, Basis for Conclusions on IFRS 16 Leases,
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F269%2FIFRS%2016%20Leases_Basis%20for%20Conclusions.pdf.
- [16] IASB, IFRS 16 Leases, link
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F269%2FIFRS%2016%20Leases_Standard.pdf.
- [17] OMFP 1802/2014, www.
anaf.ro/static/10/Anaf/legislatie/OMFP_1802_2014.pdf.
- [18]
<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:320:0001:0481:it:PDF>; p. 83.