LEASE AGREEMENTS FINANCIAL REPORTING ISSUES ACCORDING TO THE INTERNATIONAL STANDARDS

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Abstract
On January 13th 2016, the Board for International Accounting Standards published the new International Standard 16 of Financial Reporting, named as "Lease", which will substitute the International Accounting Standard 17 of financial reporting "Lease".
ISFR 16 ensures reflection of practically all lease agreements in the financial reporting, which, in is part, meets the requirements of investors regarding reliability and transparency of the information related to a financial state of an enterprise.
The Article considers the changes caused by ISFR 16, which relate to recognition of the lease agreements as the asset, their accounting and, impact on the financial reporting. Relevant conclusions are provided regarding the above mentioned issues.

Purpose. *A purpose of the Article is do show by examples a classification of the lease agreements according to the requirements of the IFRS 16 "Lease", determine the service component of the lease agreements, a basic sum of the lease, define a cost of the capitalized assets and their relevant liabilities at the beginning of the lease, and, accounting the related operations, as well as their influence on the financial reporting.*

Key words: *Element of Service; Financial Reporting; Lease; Lease Agreements; Right of Use of the Asset.*

JEL Classification: *M 41*

I. INTRODUCTION

During the periods of a financial crisis, when a financial stability is reduced, the lease is one of the alternatives of crediting. For the economic entities, the lease is one of the sources of funding. According to the international standards, accou8nting of the lease agreements are regulated by IAS 17 "Lease", which will be substituted by IFRS 16 "Lease", beginning from 2019.

Lease plays a significant role in the material and technical provision of both the small and medium-size businesses. In case of a company has already received a loan and, wishes to expand its operations, but its rate of liquidity is not satisfactory or a bank, an entrepreneur may receive in lease the assets. This is very important for rapidly developing business

According to the currently operating IAS 17, the lease agreements are classified as:

- The financial lease, which is reflected in the balance; or
- The operating lease, which is reflected in the remarks to the financial reports, only.

As assessed by the Board for International Accounting Standards:

"These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company's often-substantial lease obligations.

The new Standard will provide much-needed transparency on companies' lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy.

Based on a sample of 30,000 listed companies using IFRS or US GAAP, over 14,000 companies disclose information about off balance sheet leases in their 2014 annual reports. The future payments for off balance sheet leases for those companies totalled US$2.9 trillion (on an undiscounted basis).

Listed companies using IFRS Standards or US GAAP are estimated to have around US$3.3 trillion of lease commitments; over 85 per cent of which do not appear on their balance sheets. That is because leases to date have been categorized as either 'finance leases' (which are reported on the balance sheet) or 'operating leases' (which are disclosed only in the notes to the financial statements."[10]

In the practice, this causes that the users of the financial reports obtain information only from the explanatory notes, while a real assessment of the lease-related assets and liabilities are made independently, by the investors and stakeholders, which, to some extent, complicates analysis of a financial state of a company. Requirement of the new standard, stating that all the lease agreements shall be reflected in the balance as the asset with the right of use and as the liability – by the lease, resolves the said problem.

Recognition of the Lease Agreement as the Asset

The lease expresses the property relations, when a lessor lets its main asset to a lessee in lease, under the determined sum of money and term.

According to the principle of superiority of a content – one of the characteristics of reliability of the information of the financial reporting over the form thereof, the asset taken in lease and the related obligations shall be subjected to reflection in the financial reporting, since an object taken in lease, meets the main criteria of its recognition as the asset:

- An economic benefit gained by lessee through the use of the leased asset, is transferred to it for a certain term of usable service of such asset;
- It becomes possible to assess reliably a value of the leased asset.

According to this principle, the lessee must evaluate the asset and recognize it in the balance at the beginning of the lease and, reflect the results of the lease in the profit and loss account. If the lease is not reflected in the financial reporting, it means that the values of the economic resources and liabilities of an economic entity in-question, are reduced and, do not correspond to a reality (M.V.)

According to the currently operating IAS 17, only the financial lease is reflected in the financial reporting as the as the assets and liabilities, while the “operating lease” is reflected in the remarks to the financial reports, only

According to the new standard, registration of the lease is not changed essentially, for the lessors. The changes stating the lease agreement should be reflected in the balance as the asset with the right of use and the liability – by the lease, are mainly related to a lessee

According to IFRS 16, the following main changes are made in accounting of the lease:

- To accept an unified model of accounting for all types of lessees; and
- If the lease agreement contains the element of service, it should be accounted separately.

For the purpose of recognition of the lease in the financial reporting, it is necessary to satisfy the following two criteria:

1) First of all the company must assess, whether these agreements contain the element of lease as it is determined in IFRS 16,

2) It should be determined whether the main asset is identifiable

Suppose that a company hired a certain space in the 2-storeyed warehouse facility, to store there its goods under the 3-year agreement. For determining whether this agreement meets the criteria of recognition, let’s consider two cases:

In the first case, the lessee company occupied 100 sq.m. area in the warehouse, but a specific location of the hired area was determined by the owner (lessor) of the warehouse based on a factual use thereof and storing the goods therein

In the second case, the lessee company occupied the same 100 sq.m. area on the second floor, in sector A of the warehouse building. This place now belongs to the company and, the lessor cannot change it during the validity term of the agreement.

According to IAS 17, both these agreements are operating lease agreements and in both cases they should be reflected either in the profit or in the loss.

According to IFRS 16, the company should assess first of all, whether these agreements contain the element of lease.

For this, it should be determined whether the main asset is **identifiable**.

In the first case, the contract does not contain the lease, because the specific asset is not determined. A provider (owner of the warehouse) may substitute one place of the area by another one, during the validity term of the lease

Therefore, the agreement is to be classified not as the lease agreement, but as the service agreement and, should be reflected correspondingly either in the profit or in the loss.

In the second case, the agreement contains the element of lease, because it becomes possible to identify the main asset: the company (lessee) is a temporary holder of 100sq.m. area on the second floor, at the specific section A in the 2-storeyed warehouse building. It means that the company must recognize the lease agreement as the asset with the right of use and the liability, in the balance.

II. SEPARATION OF THE SERVICE ELEMENT FROM THE LEASE AGREEMENT

The lease agreement may contain a service element, in line with the lease.

One of the changes of IFRS 16 is that the companies should determine whether the lease agreement contain the service element.

Thus, must the company determine, whether to pay the rent only, or the service fee too, together with the rent?

Referring to the example given above, suppose that the company accepted the second version, hired 100sq.m. area in the warehouse for 3-year term and, pays 20 000 USD per year, which includes the basic amount of the rent plus weekly costs of cleaning the warehouse. In this case, the company must separate from the total sum (20 000 USD) the rent and the service fee.

According to the widely spread practice, the assets are identified according to the market prices.

Suppose, that the company can hire the analogical sq.m. area on the market for 19 000 USD for a year, without service and, at the same time, pay annually 1 500 USD as a service fee. The rate of discount is 10%.

In this case, the price of the agreement may be distributed in two components and introduced as follows:

Table 1. Separation of the service element from the lease agreement

Components	Market value of the service	Share	Distribution between the components
Lease	19 000	20 000 * (19 000/20500)	18 537
Servicing	1 500	20 000 * (1500/20500)	1 463
Total	20 500		20 000

Thus, the sum of the agreement 20 000 USD should be distributed in two components: Rent –18 537 USD and the Service Fee – 1 463 USD

If the service element is an insignificant part of the Lease Agreement, the Lessee shall have the right to consider the agreement as the lease agreement, only.

III. REFLECTION OF CHANGES AT THE LESSEES

The main change of the Standard relates to the requirement to Lessees, to reflect a financial state of the lease in the form of the assets and the liabilities. The lessees should apply one and the same approach towards all leases' The operating lease will not exist anymore, within the scopes of IAS 17. According to IFRS 16, any lease is deemed as funding the operation (deal) at the beginning of the term of lease. In the report of the financial state (balance), this operation is reflected as follows:

Table 2. Reflection of the Lease in the Report on Financial State

Content of the Operation	Asset	Liability
Deal funding (receiving the asset into the lease)	Asset with the right- of- use (ROU)	Obligation on the lease

IV. EVALUATION

The asset reflected in the balance, is the right of use of the property received under the lease, a so called right-of-use (ROU).Its value at the starting moment of the lease is equal to the sum of current (discounted) value of the rents and the direct initial costs of the lessee. Besides, the initial value of the assets may be corrected b y the sum paid in advance or the received payments (lease stimulation) at the beginning of the lease by the lessor, as well as by value of the obligation for re-cultivation and restoration (if possible)

Further, the right-of-use as the asset, must be accounted as the "Main Asset" according to IFRS16, with charging the wear (amortization) during the entire period of the lease. Towards it, the IAS 36 "Impairment o Assets" is also applied. Correspondingly, the lessee shall reflect the costs of amortization and impairment of the assets (ROU) in the profit and loss account, in a form of the financial costs

At the beginning of the term of lease, the asset and the liability shall be reflected in the lessee's balance sheets by one and the same amount, with the net lease obligation

The net lease obligation is the difference between the total lease obligation and the financial (percent) cists

If the initial direct costs of the lessee is added to the sum of the asset, the obligation should be reflected in a sum equal to the asset's value, which is calculated without the direct costs

For the lessee, the total lease obligation is a set of the minimal rents and of all non-secured residual values accumulated in favor of the lessor

In addition to the above, one of the significant changes of IFRS 16 is the following:

The lessee must recognize the right-of-use of the asset and the relevant responsibility for its financial state. At the same time, the asset should be amortized during the term of the lease.

There exist two exceptions from this rule:

1., In case of a short-term (12 months or less) lease; and 2. In case of the assets with a comparably low value furniture, computer), the Standard allows an exception (the lessee may be released as he thinks it fit) from observing a general rule [17].In this case, the lessee companies account the lease as the operating lease as per IAS 17.It means that neither the assets nor the liabilities are reflected in the Reports on Financial State and, are reflected in the profit-and-loss account by a total sum of the lease costs.

By the data of the above given example related to the warehouse, we may assess the lease agreement under IAS 17 and IFRS 16:

In both cases, the annual rent is 20 000 USD together with the service fee. All the obligations are to be performed at the end of a year, The interest rate is 10%, term of lease – 3 years.

No other additional terms and conditions exist.

How IAS 17 and IFRS 16 can assess this agreement?

According to IAS 17, it should be established first of all that the lease lf the warehouse is functioning really. (i.e. the lessee started use of the asset received in lease) and the second, the lease is to be classified as the financial or the operating lease, proceeding from the condition that the lessee company annually recognizes 20 000 USD in the profit-and-loss as the costs of the operating lease.

According to IFRS 16, such the classification is not required, since one and the same unified model is spread over accounting of all the leases

In the last case, the company should determine:

1) What is the lease under IFRS 16?

Referring to the above example, the asset is identifiable, that means that it is the lease

2) In addition to the element of lease, are there any other element in the Agreement? In the given case, the element of cleaning should be separated from the element of lease.

18 537 USD is the element of lease.

1 463 USD is the element of cleaning.

3) For calculating by the company a sum with which the asset should be recognized in the financial reporting, it is necessary to make a discount from the rent. In our example, the discount rate is 10%

4) It should be noted that in practice, it is not so easy to determine this rate. According to the Standard, it is factually a norm of the internal return, i.e. this is a rate of a real value of the asset, which is related to the rent and the direct costs, including a non-secured residual value of the asset. If it is difficult to calculate this rate the lessee may apply the rate requested by creditors for the same amount of the loan and for the same period.

In case of our example, an annuity of the cash flows takes place. 18 537 USD must be paid at the end of each year, during 3-year period. In case of 10% rate in 3 years, the rate of annuity will be 2,4869, while he sum to be paid during 3 years, will be 2,4869 * 18 537 = 46 100 USD

In the future, IFRS 16 will spread over the “right-of-use” (ROU) of the asset, the sum of amortization 46100 / 3 years = 15 367 (in conditions of the linear method) will be charged on it and, if required, IAS 36 “Impairment of Assets” will also spread on the assets.

5) The financial costs will be charged on the lease obligations according to the table given below:

Table 3. Charging the Financial Costs on the Lease Obligations

Years	Initial balance of the obligations	Interest Rate	Sum to be paid	Closing balance of the obligations
1	2	3 + 10%*2	4	5=(2+3)-4
1	46 100	4 610	(18 537)	32 173
2	32 173	3 217	(18 537)	16 853
3	16 853	1 684	(18 537)	0

Table 4. Accounting records according to IFRS 16

Period	Content of the operation	Sum	Debit	Credit
At the beginning of the lease	Right-of-use of the asset	46 100	Right-of-use of the asset	Obligation on lease
At the end of the first year	Charge on the interest rate	4 610	Costs of interest rate	Interest Rate payment obligation
		20 000		Bank Account
	Rent to be paid	18 537	Obligation on lease	
		1 463	Costs of cleaning	
	Charge on the amortization	15 367	Costs of amortization	Right-of-use of the asset

The Table 5 below, shows the effect of the lease operations on the financial reporting (report on the financial results) according to IAS 17 and IFRS 16

Table 5. Effect of the lease operations on the financial reporting (report on the financial results) according to IAS 17 and IFRS 16

IAS 17		IFRS 16	
Annual rent	A full recognition to be reflected in the profit-and-loss account	Costs f the interest rate	4 610
20 000		Costs of amortization	15 367
20 000		Service costs	1 463
		Total	21 440

Table 6. Distribution of the lease-related costs by years

Indicators	Year 1	Year 2	Year 3
Amortization	15 367	15 367	15 367
Financial cost	4 610	3 217	1 684
Service costs	1 463	1 463	1 463
Total	21 440	20 047	18 514

If consider the lease according to IAS 17 As the operating lease, then, the costs of Year 1 calculated according to IFRS 16, turns higher: 21 400 > 20 000, but insignificantly, while the costs of Year 3 – vice versa: 18 514<20 000

V. CONCLUSIONS

- The main change of the Standard relates to the requirements to the lessees, to reflect a financial position of the lease in a form of assets and liabilities
- Except for the additional requirements to the lessors, to reflect the information in the financial reporting, no other financial effects are expected.
- Financial reporting will be changed considerably for the lessees, on account of the operating lease. Namely, the new assets and liabilities will appear in the financial reporting (balances). At the same time, if the assets will only be mentioned in the financial reports, then, reflection of the liabilities by a considerable value, will have a certain impact on the investors and creditors ,since they are the suppliers of the risk capital and, analyze correlation of the company's own and borrowed resources to the total number of the sources .By view of estimation of the allowable financial risk, the latter is increased by reduction of a share of the company's own capital, on account of increase of the size of liabilities. At the same time, the index of financial stability (index of the long-term liabilities) will be changed considerably
- Some changes are expected in the cash flow reporting, namely, the sum of the lease obligations is the money gained from the financial activity, while the sum of the interest rate is a cash flow from the operational activity
- It seems to be difficult to determine overall results of the new standard, since they will cause certain changes in the legislation. For example, some changes can be made in the tax registration of the lease. However, the main changes will be made in recognition of the lease agreements in the financial reporting and, the actual financial tools of the company will became clearer.

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