Accounting Concept Of Lease Contract

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Abstract: In the scientific paper is made an attempt to explore lease contracts in terms of their accounting aspects, to identify discussion points and unresolved problems related to their classification and accounting treatment and to formulate and justify conclusions and recommendations for effective resolving of the identified outstanding issues.

Keywords: leasing, lease contract, finance lease, operating lease, accounting. JEL (M)

1. Introduction

Nowadays a lot of active enterprises experience lack of available financial resources to invest in the production process and in particular in the renovation of production equipment in accordance with modern technologies. At the same time securing investment capital through bank loans is difficult, especially in times of financial instability. That is why one of the most effective and affordable ways to finance the processes of renewal and development of production nowadays is lease.

Despite the widespread usage of lease as a form of financing in Bulgarian practice - it is a subject of many discussions. Reasons are various: inconsistencies in the concepts and terminology of lease contracts used in national legislation; lack of extensive research in literature[1] and adequate interpretations and expert explanations on its legal, accounting and tax treatment; differences in the requirements for its accounting and presentation of information in financial statements, placed in National Accounting Standard 17 Leases and in International Accounting Standard 17 Leases. All this shows that for lease transactions and their regulatory base exist unresolved issues that determine the relevance of the topic and its significance. Therefore this scientific work aims to explore lease contracts[*] in terms of accounting, to highlight controversial issues related to their classification and accounting treatment and to formulate and justify conclusions and recommendations in order to effectively deal with identified outstanding issues.

The term "lease" is derived from the English verb "to lease" - rent, give / take rent. [2.] The word "rent" is associated with the providing of property for use against payment, respectively to "pay for temporarily usage of a thing" [3.] This gives reason to determine that the lease is a specific transaction in which one party, the lessor (landlord) gives the other party, called the lessee (tenant) asset against payment.

As a kind of contractual arrangement whereby the "lessor is obliged to provide property for use against remuneration" [4] lease covers a wide range of relationships. They occur most often in relation to both participants - the lessor and lessee, in wider lease transactions may arise also relationship with third party - a lease agent that performs the organization of leasing operations, funding bank or a trust company (the owner of the object).

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[1] See .: Brezoeva, B. (2012). Leasing - financial, operational, reverse, terminated, subleasing, Sofia: ORKP "Thought"; Dushanov I. Dimitrov, M. (2015). Course in company accounting. Sofia: Trakia M .; NAYDENOV, B. (2007). Leasing. Financial and legal aspects. Sofia.

* In the scientific work lease contract will mean not only the document «lease», but also legal trade relations, together with its legal, accounting and tax consequences.

[2] See .: Garnev, N., HAYTOV, Ts. (2004). Accounting Dictionary (English-Bulgarian, Bulgarian-English), CM Publishing, p. 104

[3] BULGARIAN dictionary. Retrieved on February 10, 2016 from http://www.t-rechnik.info/home/search; BULGARIAN dictionary AZ (1973). Third Edition. Sofia: Science and art.

[4] Commercial Law, art. 342 // Official Gazette, 1991, issue. 48, last. amend. 2015, issue. 95. Retrieved on February 10, 2016 from http://lex.bg/laws/ldoc/-14917630

Involving more than two parties in leasing transactions is often due to the application of specific leasing schemes that include complex arrangement of property relations. In these schemes are often intertwined elements that are typical for other non-financial relations and financial products. The aim is to create the best possible financial instrument through which companies-lessees to obtain new assets (in technical and technological aspect) and so to update the material and technical base, even without having enough cash.

Despite the complexity of the leasing scheme for each leasing transaction, three main elements can be distinguished:

- Subject of the lease - assets assigned for use against payment;
- Parties of the leasing deal - the lessor and the lessee, while wider leasing transactions may include third party - a lease broker, financing bank or trust company;
- Lease contract - the document, which regulates the relationship between the participants in the lease transaction, resp. legal terms of the trade agreement between the parties participating in the lease transaction in connection with the settlement of relations between them.

Relevant national accounting standards define two types of leases: a contract for financial and contract for operation (operating) lease[5]. They are distinguished by the characteristic “degree of transfer of risks and benefits associated with the leased asset”[*]. For them, the legislator provides current and periodic reporting in the financial statements to be consistent with the principle of “substance over form”[6].

When the lease is financial then all risks and benefits of ownership of the asset are transferred largely to the lessee. It is possible, but not necessarily agreed to be transferred also the ownership of the asset.

A special feature of the finance lease is that the transfer of all risks and benefits is directly conditioned by fulfillment of specific criteria: the transfer of ownership should be at the end of the lease term; contract should contain an option to purchase the asset by the lessee and to be very likely to take advantage of it; the price at which it is expected the lessee to purchase the asset at the end of the lease to be substantially lower than the fair value at that date; term of the contract to cover the majority of the economic life of the leased asset, even if ownership is not transferred; lease asset to be specific and only the lessee to be able to use it without making substantial changes to it; in the beginning of the lease contract the present value of the minimum lease payments to equal the fair value of the leased asset[7].

Contract for operating lease is each lease contract other than a finance lease. For this kind of lease the risks and benefits of ownership of the asset remain for the lessor.

The classification of leases by “level of transfer of risks and benefits associated with the leased asset” can be presented schematically as in figure № 1.

[5] See .: NAS17 Leases, p. 3.2. Retrieved on February 10, 2016 from http://balans.bg/178-nss-17-lizing/

[*] Risks associated with the asset most often are result of the irrational use of the asset, its technical obsolescence, changes in the economic environment and others. While the benefits of the asset are mainly related to income generated as a result of its use, the presence of residual asset value and rising prices in the market.

[6] ACCOUNTING Law, Article 26, item. 8 (2016). Sofia: Sibi.

[7] See .: NAS17 Leases, ie. 3.3. Retrieved on February 10, 2016 from http://balans.bg/178-nss-17-lizing/

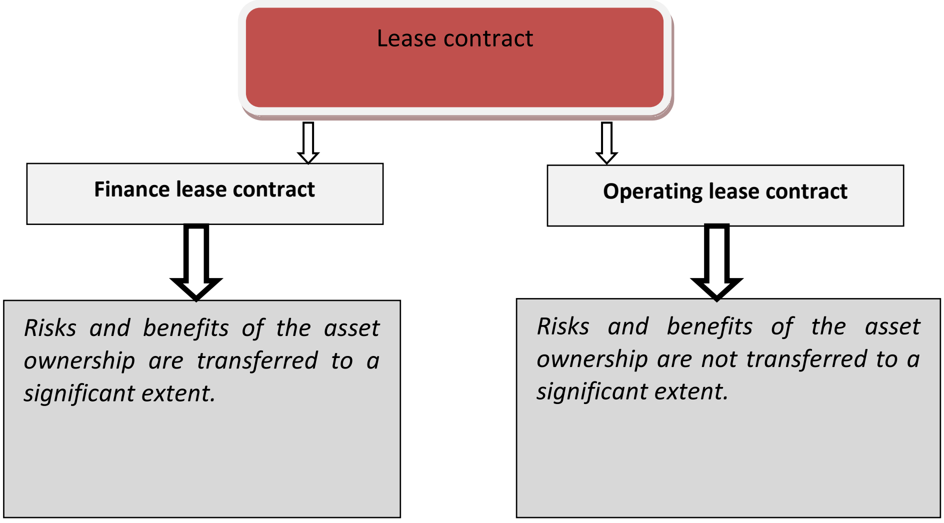

Figure 1. Classification of leases by "level of transfer of risks and benefits associated with the leased asset"

Table 1. Differences in the accounting treatment of finance lease and operating lease contract

Finance lease contracts	**Operating lease contracts**
The asset is written off from the accounts of the lessor and is recorded in the accounts of the lessee.	The asset remains to be kept in the books of the lessor.
The lessee books depreciation on leased depreciable assets, although they are not his property.	The lessor books depreciation of rent depreciable assets, although he does not really use them.
Lessor recognizes two types of revenue - interest for the term of the lease and profit / loss equivalent to the profit / loss that would result from the sale of the leased asset at sale prices.	The lessor recognizes current income from rent for the term of the lease.
The lessee takes into account current interest expenses for the term of the contract.	The lessee accounts current rental costs for the duration of the contract.
In the contract it is usually inserted the option to buy the leased asset after the expiry of its term.	The contract does not provide the option to buy the leased asset.

The classification of lease contracts is essential for the development of the accounting policy of enterprises and the development of their chart of accounts. It is also important for the accounting and presentation of information for leases in the financial statements of the lessor and the lessee.

Accounting of leases is based on a set of requirements in section. 4 and 5 of the National Accounting Standard 17 Leases. These requirements outline the parameters of the two accounting models - a model for accounting for finance lease contracts and model for accounting of the operating lease agreements, which together make the foundation of the accounting concept of lease contracts.[8].

To characterize more completely the accounting concept of leases, it is important to analyze in depth the two models for accounting of lease contracts, in order to reveal common characteristics and differences between them and to identify the specifics and problems surrounding their practical use.

Comparative analysis of contracts for financial and operational lease shows that among them there are common characteristics. They are related mainly to identical economic substance of financial and operating lease (both financial and operating lease have contract agreements under which an entity provides asset to another entity against payment) and their legal regulation for accounting purposes (they are leases, so they

[8] Examples of practical application of accounting models for leases can be seen at: PANCHEVA, St. (2014). Enterprise Accounting (book of tasks and case studies). Sofia: NBU, p. 68-73.

require specific documentation and accounting reporting, the information about them is presented in the financial statements of both companies - lessor and lessee). Between them stand out also differences that might be presented as in table № 1.

Analysis of both forms of lease also shows that finance and operating lease allows businesses to be competitive, to develop dynamically and to follow the latest technologies. Yet, for financial leasing, opportunities available for parties involved in the leasing transaction are larger - lessee acquires and uses the asset without paying once its equivalent, and the lessor receives deferred with interest and the amount of the leased asset without taking the risk of its usage by the lessee.

When examining the accounting treatment of the two lease contracts is reasoned that they are clearly distinguished based on specific criteria and for their accounting treatment guidance is provided. In these guidelines are revealed some gaps and deficiencies (except amortization expenses other costs, related to the use of leased assets that the lessee under a finance lease and the lessor under operating leases can recognize and book, are not specified, is not provided an option for removal from the balance of the lessor and reporting on off-balance sheet accounts of the asset under operating lease, although that he will not benefit from it for a long time; it is not clearly defined which of the parties to the lease must bear the cost of subsequent repair grants of the rentals assets, etc.), but they generally do not prevent the development and implementation of legal models for accounting of leases.

Issue with accounting treatment of leases also creates their ambiguous distinction. The reason is that whether a lease is a finance or operating lease depends mostly on the nature of the transaction described in it. It is therefore important to analyze the terms of any signed lease in order to establish the economic substance of the transaction and check for the presence of one or more fulfilled criteria related to classification of contract as finance or operating lease.

Regarding accounting classification of leases difficulties arise from the fact that this classification is not directly determined by the legal form of the contract. For example, finance lease contracts may be arranged as rent contract or leasing sale/purchase contract that does not substantially alter their treatment. This means that even if a legal contract does not bear the name of a lease but is associated with providing of assets against a payment, it will fall within the scope of the accounting concept of lease contracts.

As a result of the study of leases can be concluded that they are easy to use, efficient and flexible form of financing of investment projects, which have a number of benefits, including eliminates the risk of obsolescence of its assets; release funds for more profitable investments; provide tax relief; increases the elasticity of the investment policy; it provides funding with less one-off costs; it provides an opportunity to avoid the costs associated with obtaining borrowed funds; usually are provided better terms and lower interest rates compared to bank loans and guarantees are not required (pledges, mortgages, etc.); very often a payment of an initial lease payment is negotiated after a certain period of use of the asset; documents are made simpler, faster and cheaper than other forms of financing; it provides the opportunity for timely renewal of assets and increasing technical and technological level of production even if the lessee has insufficient financial resources, etc. At the same time they have a disadvantage – when the deal is negotiated in foreign currency other than national, there is currency risk both for the lessor and lessee. Furthermore, for the lessor there is risk of receiving physically and obsolete assets after the expiry of the lease, which can hardly be realized at their residual value. For the lessee risk is related to economic unprofitable transaction consisting in excess of lease payments over the economic benefits from the asset, especially if it is temporarily not in use. As a result it can be concluded that lease is convenient and flexible form of corporate financing, which has a number of advantages over commercial transactions for the purchase and sale of assets, bank loans and rent, but hides some risks for parties participating in the transaction[9].

[9] Between lease contracts, contracts of sale, bank loans and rent should be made difference. See .: BULGARIAN dictionary. In: http://www.t-rechnik.info/home/search

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