IFRS 16 – LEASINGUL

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Abstract. *IFRS 16 is a new standard which is waiting to be approved by the European Union and will be applied beginning on or after 1 January 2019. IFRS 16 specifies how an IFRS reporter will recognise, measure, present and disclose leases. This standard provides a single lessee accounting model, requiring lessees to recogniseassets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value.*

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Introduction

In order to be successful, to have a great business, you have to invest in something profitable. But then appear questions like: What should I invest? From where do I get the necessary resources?, How much time do I need to repay the invested money? Or should we think about renting, buying, outsourcing?

For more than 10 years, IASB (International Accounting Standard Board) and FASB (Financial Accounting Standard Board) are working together to find a solution aimed at improving transparency in the lessee's financial statements, generated by leasing, demanded by investors, financial analysts and regulatory authorities. Based on this idea, on 13 January 2016 the IASB has published a new accounting principle: IFRS 16 – Leasing.

Today, operational leasing contracts are not recorded in the lessee's financial statements, which has an impact in comparing the entity's balance sheets, the ones which operates in the same field of activity, in particular between those entities which purchase goods with their own money and those which are leasing the goods. A study made by IASB and FASB shows that (www2.deloitte.com):

- about 85% of leasing contracts are not recorded in the trader's financial statements;
- by introducing the IFRS 16, more than 2.000 billions of $ will "appear" in the financial statements.

The implementation of IFRS 16 is planned on 1 January 2019, and for an easier transition to the new principle it is necessary to practice in advance. The challenge consists in anticipation of all operative adjustments that will be introduced with the new principle and the prompt activation of the set of operations involved: purchases, general services, information systems, treasury, corporate and legal affairs.

According to BNP PARIBAS GROUP, the new standard applies to all companies that report financially under IFRS, and in particular to listed companies and their subsidiaries, and companies incorporated in one of the States that adopted IFRS's at the local level.

The new standard seeks to better reflect the real consequences of economic transactions, but also to ensure the very necessary transparency regarding the assets and liabilities arising from the leasing contracts of the companies, which means that the off-balance sheet financing contracts stops to be unrecognized. Also IFRS 16 is expected to facilitate comparisons between the financing companies and borrowing companies. Another important aspect is that the new standard is a review of how companies account for contracts and states that they all need to be reported as assets and liabilities in the user's balance sheet.

Leasing – source of alternative funding for economic entities

To be functional, companies needs financial resources, to implement the value creation mechanism: to achieve a good or service. Any productive activity, in fact, requires the profession of human elements, material or non-material elements that combined between them allow the company to perform its business. Knowing how to choose the most appropriate sources of funding is not an easy thing to do, especially since choosing one at the expense of another may lead the company to financial imbalance, thus endangering the continuity of activity. (Deloitte, "Analyze IFRS 16")

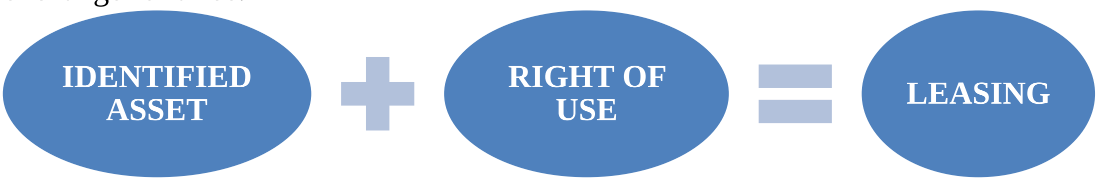
Leasing has now become, even internationally, one of the most widespread means of financing. The new operation, achieving a remarkable economic success, brought leasing into the spotlight of the economic agents. It also comes as a source of alternative funding for the purchase of assets by completing a contract for their use without being included in the property.

Typically, businesses keep their in their property asset and record that investment in their balance sheet. However, for a business, it is essential to use those assets (equipment, buildings or machines) and not simply to own them. A means of obtaining the right to use fixed assets is the purchase. But an alternative to this option is renting (leasing).

Leasing is a mechanism for adapting the capital market to the reduced capacity to finance investments. Through it, a good is leased and a monthly fee is paid for using it for a period of time agreed and according to the special conditions stipulated in the lease contract. Leasing is therefore not, as many of us believe, a sales-purchase contract, but much simpler a rental agreement. So, it is wrong to say, "I bought this good in leasing!".

1.1. The determinants according to the new standard

The leasing is a contract or a part of it which 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 substantial rights to replace it.

A supplier has the right to be able to change the good when:

a) has the ability to change the good without the customer being able to prevent it, and
b) will have an economic benefit in exercising this right.

The right of use for a period of time is when the customer has the right to obtain economic benefits through the use of the asset throughout the all period. Also, the client has the right to determine how and for what purpose the asset is used. It has the right to use the good for all right of use's period, without the supplier having the right to change the instructions for use.

1.2. How does a Leasing work?

Leasing means leasing assets through which the lessee (the tenant) receives the benefits of using the leased asset and the lessor (the leaser) finances the acquisition and depreciation of the capital investment. For the use of this asset, the lessee pays the lessor a rent or fee. That fee includes the depreciation of the leased asset, an opportunity cost related to the advanced lessee's funds to buy the asset and a profit margin of the leasing company.

Therefore, the ownership title to the leased property will remain at the lessor and the lessee may purchase it at the expiration of the lease contract, but only if that option was mentioned in the same contract.

Hence, in general, there are three economic subjects in a leasing contract (www.fondounimpresa.ch):

- the one who produces, manufactures or owns a good - the lessor;
- a leasing company;
- the tenant, meaning the client.

The manufacturer and the leasing company are linked to a sales contract, but the leasing company and the lessee are linked to a renting contract.

The advantage of a lease to a loan results from the fact that the lessor holds a better position than a lender if the company using the asset is in financial difficulty. When the lessee does not comply with the requirements set out in the lease contract, the lessor has a stronger right to recover the leased asset, because he is the owner of the asset. On the other hand, the lender may have costs and delays in recovering the asset that has been funded, either directly or indirectly. Given the fact that the lessor encounters a much lower risk than other sources of finance used to buy the asset, when the company requesting financing is more risky, the financing provider has one more reason to propose a leasing operation and not a loan (granting a loan).

According to Visan Dumitru ("Accounting of leasing transaction", 2013, p. 25), leasing, as the operation itself, starts from the person who wants to rent a product (user) and in this regard calls to a leasing company completing an application specifying the asset that is the object of the lease.

The lessor is the owner of the good until the expiration of the contract, unless the lessee makes a firm and irrevocable offer of purchase of the asset upon expiration of the contract. So, there are basically three types of leasing: financial, operational and leaseback-up.

Financial Leasing versus Operational Leasing

Leasing is an alternative to long-term loan financing and with secure guarantees. Therefore, it causes the appearance of two issues that need to be solved, as the debt and the cost of financing those operations. Thus, leasing, as a source of funding, is classified as a borrowed capital.

The lease confirms that the lessee has the right to use the asset, but instead has to pay a series of regular rates to the lessor, the owner of the asset. The lessor may be both: the asset manufacturer and 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 leasing begins to generate effects.

The use of an asset can be done through a lease. 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.

There are two types of leasing:

2.1. Operational leasing

Operational leasing is also called *maintenance lease*. It can provide both financing and maintenance services. IBM (International Business Machines) is one of the pioneers of operational leases. The main types of assets that are involved in such transactions are heavy vehicles and trucks and computers with high computing power. In the case of this type of leasing, the lessor leases, with the asset, the insurance and the maintenance services. These costs are included in the rent of the asset.

The existence of a cancellation clause in the operating lease gives the lessee the possibility of renouncing the lease and can return the asset before the contract expires. Assets are often not fully depreciated for the duration of the lease and this contract is shorter than the economic life of the asset. The lender wants to recover the value of the asset by reselling the equipment or renewing the contract with the old user. By this, the lessor is subject to a risk of non-use of the asset in certain circumstances.

According to Ciorba A. (www.andrei.clubcisco.ro), operational leasing also present some characteristics. The most important ones are:

- ✓ *assets are not fully depreciated* and this means that the payments made by the lessee are insufficient to cover the full cost to the lessor. This is due to the fact that the operating contracts have a shorter duration than the economic life of the asset. Thus, in order to recover the costs, the lessor has to renew the contract with the same tenant or with another, or by selling the asset;
- ✓ *all costs related to the insurance and maintenance of the asset come to the lessor*;
- ✓ *the existence of the cancellation option*, giving the lessor the right to cancel the lease before the expiration of the term. If it requests cancellation, the lessee must return the lessor's asset;
- ✓ *the contract has a shorter duration, even a few months*.

2.2. Financial Leasing

This type of transaction is basically a lending operation. It is a financing contract through which a financial company acquires, on behalf of an enterprise, an asset that is necessary for its business, thus obtaining an income. In this case we have a triple report: the producer of the good, the user and the financier who has its own financial interests by facilitating the transaction. Thus, the lessor retains the ownership of the asset, and the collateral is provided by the asset itself, thus facilitating the bank financing function. In this case the leasing company assumes an intermediary position between the supplier and the user.

Financial leasing is also called *capital leasing*. The rented asset is new and the lessor acquires it from the producer or distributor, but not from the lessee user.

Financial leasing is the opposite of operational leasing and has the following characteristics:

- ✓ *does not provide insurance and maintenance services to the lessee*;
- ✓ *it is fully depreciated;*
- ✓ *the tenant has the right to renew the contract upon expiration of the existing one;*
- ✓ *the contract can not be canceled, so the lessee must make all the payments or there will be a risk of bankruptcy.*

These features determine it as an alternative method for purchases.

The financial reality of financial leasing contracts consist in the fact that lessees will gain the economic benefits, resulted by using the assets on the longer part related to the economic lifetime. In exchange for this right, a lessee has the obligation of paying an amount almost equal with the fair value of the asset, as well as the specific financing expenditures. The leasing payments should be divided into financing expenses of the leasing and the reduction of not paid debt. (Tulvinschi M., 2010, p. 3)

In Solomon's work ("A new perspective of economic prevalence on legislation in leasing contracts", 2016, p.13) is said that at the beginning of a contract an entity will assess whether the contract is or contains a lease. A contract is or contains a lease if it confers the right to use an identifiable asset for a period of time in exchange for a consideration. A period of time can be described in terms of the quantity of products of an identifiable asset, for example the number of production units that an equipment produces.

Depending on the type of asset underlying the transaction, Gheorghiu, in "Forms of the leasing contrats" (2006, p. 21-28), affirms that there are several forms of leases:

1. the financial leasing contract;
2. the operational leasing contract;
3. the real estate leasing contract;
4. a leasing contract having as its object the right to use computer programs;
5. lease-back contract;
6. time-sharing contract.

Why Leasing?

Producing companies and foreign trade companies that are producing the products, the machinery industry, the specialists of those organizations need, in order to be able to negotiate knowingly, a series of data that will explain the reason why the partner makes use of the request hiring a certain product or investment good. When the specialist has managed to determine the reason, he has to prepare the supporting arguments for concluding a lease. At the same time, the specialist must know the possible criticisms that the negotiating partner might involve in order to be prepared to counter them down. (Voiculescu D., 1985, p. 128-133)

As Vintila said in her paper "Theoretical and practical aspects of leasing operations" (2003, p.25), the leasing operation, bringing together the financing, production and marketing, represent interest to all parties involved, which exceeds the classical limits of the purpose for which the respective contract was concluded (sale / purchase between the financier and the supplier or leasing between the financier and the user).

It is known that leasing has several advantages that place it in the top of preferences of economic agents. This allows almost complete coverage of third-party asset financing. Leasing saves liquid capital, solves financing problems, rigorously plans future spending, but also rationalizes activity through specialization. Depreciation plan is simplified because the rates are fixed, and the lessee knows exactly how much they have to pay. Most often, leasing is the only way to finance small and medium-sized enterprises (SME) that are rapidly expanding but with financing problems.

The basic principles of choice between two sources of funding refer to: the amount of lease payments and the amount of payments for credit are incomparable; we can not compare the credit interest rate with the commission established by the leasing company for its services; we must take into account all of the expenses for maintenance for every possible funding source; we must take into account the tax benefits for leasing and for credit; the analysis of cash flows should be consistent with the term of full depreciation of the asset, without limitation to the maturity terms of the sources of funding; all cash flows are discounted to the same period. (Simon A., 2015, p. 68)

Even through leasing is the most demanding method of financing, it also has disadvantages. The rented good always remains in the property of the leasing company and the lessee is obliged to use it appropriately by performing the services prescribed by the manufacturer. In the event of an incident, theft or technical failure, the leasing company must be notified immediately. In case of total destruction of the rented property, the lease is canceled under the same conditions as the early termination: the rental amount increases retroactively at the beginning of the contract. At the time of the restitution, the lessee must assume any damage to the rented property and putting into service the asset under the contract, which is necessary to ensure the security of the rented property.

In the case of a vehicle rented to a private individual, in general, it can only be used by people living with it in the same house and holding a driving license. It is therefore forbidden to borrow the vehicle to a third-part. It is also not possible to make driving lessons with that good; such a authorization must be required by the leasing company. Extra kilometers are invoiced when the vehicle is returned at a price fixed at the end of the contract, but quite high. Otherwise, if fewer kilometers have been made, they are not refunded. So the tenant must be very careful about what is stated in the lease.

Conclusions

Leasing has been adopted by companies or businesses that prefer to save their own financial resources for other activities than to invest it in the purchase of goods. Therefore, leasing is a financing operation that allows the company to hold the necessary assets, without the need to obtain a capital to buy them, but only with the payment of a rent.

It is possible to obtain any asset through leasing: real estate properties (cars, office equipment, office furniture), but also real estate (the object may be a building built or to be built, may take into account the land and the construction or only the construction).

Any leasing company reserves the right to be informed about the client's financial statements: therefore, leasing will only be considered for strong, well-targeted companies that can provide the leasing company with all the necessary collaterals.

Before signing a lease, we need to pay attention to requesting a clear, precise and written description of the terms of the contract (termination, warranty, maintenance). It is also necessary to check whether or not the owner of the object becomes the owner of the object at the end of the period fixed in the lease, this does not always happen and depends on the type of contract. Another important point is that it has to be calculated how much the lease will cost in the end, considering the duration of the contract, because rarely it is financially advantageous. In the case of a vehicle, it is always necessary to check how many kilometers can be made per year and how much will be paid for each extra kilometer traveled.

As regards financial and operational leasing, I consider that the financial leasing is most advantageous than the other one, because at the end of the contract the rented property can be bought and thus, enter into the lessee's property against a residual value. On the other hand, the object of the operational lease can not be purchased. Operational leasing is more rigorous than the financial lease. The client who is seeking an operational lease must establish from the beginning the clear structure of the contract. The lessee must clearly indicate the number of kilometers traveled during the lease, the repairs to be made and the exact term of the contract.

Also, the companies in continuous development will always resort to financial leasing because they want to have no limit to 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 rental vehicle, and clients of such a leasing are companies that have a standardized, budget-based management as corporations or large companies. In addition to hiring, contract rates may include fuel card services, tire tread, or other costs. At the end of the period mentioned in the contract, the asset used will return to the operational leasing company which will decide what will happen further with the asset.

Every economic agent is free to choose what is beneficial to his business, which will lead to growth and development of this one. Today companies need such funding, as they do not all have the necessary funds to directly purchase the goods needed to carry out their own business.

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