

## ACCOUNTING TREATMENT OF ASSETS AMORTIZATION TAKEN BY MEANS OF FINANCIAL LEASING REGIME

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### **Abstract**

*In conditions of fast technical progress, the financial leasing has become a necessary element so as to finance the investments, and towards a real economic growth. The financial leasing has generated within the lessee accountancy both exploitation expenses as regards the amortization afferent to the assets, as well as the financial expenses. The main objective of this paper consists in emphasizing the issues the amortization of the asset taken by financial leasing, in accordance to the international standards, specific to the leasing, tangible assets and depreciation of assets. An especial attention should be dedicated to the result, where changing the useful lifetime of the assets on financial leasing regime has effects over the truthful reflection of financial position and performances of a lessee. One might also outline that the time of asset utilization represents a factor, which has influenced the decision of refinancing by leasing.*

**Keywords:** accountancy politics, accountancy estimation, useful lifetime, tangible asset, lessee.

**JEL classification:** M41, F30.

### **1. INTRODUCTION**

The financial leasing represents an alternative to bank loans, as considering the financial point of view. The progress of leasing at world level has been strongly connected to the requirements of leasing beneficiaries, which were acting within various branches of the economy.

Considering the point of view of the lessor, the leasing operation signifies "buying an asset for renting purposes, followed by renting it for selling purposes" [Matis, 2003, 251]. The main difficulty specific to the leasing consists in "the opposition between the economic and judicial" [Malciu, 2000, 178]. According to French authors Bernard Esnault and Christian Hoarau, the accountancy represents "a technique of quantitative level, of collecting, processing and analyzing the information, as regards the economic and judicial events of an enterprise" [Esnault, Hoarau, 1994, 137]. Taking into account the judicial aspect, an asset representing the object of a leasing operation signifies a capital for the lessor, since it is part of its patrimony. Talking about the economical aspect, an asset represents a technical capital provided for the lessee. The financial leasing is one of the most eloquent examples of carry-

ing into effect the principle of economics prevalence over that judicial. Disconnecting the ownership and exploiting the assets, the leasing has been financed the technical capital by the revenues emitted after its exploitation.

A frequent form of the financial leasing is represented by triangular operations specific to leasing. The initiative of such operation usually belongs to the user, which needs some assets and carries out on prospecting the market, in order to identify a potential supplier and a financier. After the supplier and the user agree over concluding a sales contract, the user can address to the financier an application, including: data related to the technical-functional characteristics of the asset aimed, data related to financial situation, to identifying the supplier and details negotiated as concerns the sales contract. If the financier accepts the application, he will enter into the business and will take over starting with that moment, in own responsibility, the negotiation with the supplier.

The main feature of the leasing contract consists in its atypical character, meaning that it is situated between the leasing, buying and crediting contract, but it should certainly not be regarded as a combination of these. In these conditions, the leasing contract can be qualified within the specialty literature as a contract of „sui – generis” type [Malico, Wunder, 2003, 60]. This character of the leasing contract is based upon the existence of two leasing operations: the usufruct function and the financing function.

## **2. RECOGNIZING THE FINANCIAL LEASING OPERATIONS WITHIN ACCOUNTANCY OF THE LESSEE**

The elements of financial leasing should be analyzed in accordance to International Standards of Accountancy, since the accountancy of an enterprise is marked by two fundamental facts: on one hand, by the normalization and stipulation of general accountancy, and on the other hand, by the development of accountancy research [Colasse, 2000, p.20]. The problem of registering a balance sheet of assets used, and in accordance to a financial leasing contract, was for the first time analyzed in USA. The American standard as regards the leasing is represented by FAS 13 „Leasing”. This was issued by the Financial Accounting Standards Board (denoted by FASB). The accounting standard FAS 13 „Leasing” imposed the fact according to which the immovable, part of a financial leasing contract, should be seen as tangible assets into the lessee’s balance sheet; subsequently, a debt of equal dimension will be registered into the liabilities [Walton, 1996, 32]. In order to regulate the leasing, the International Accounting Standards Board (IASB) issued the standard IAS 17 „Leasing contracts”. Both international bodies launched in March 2009 a discussion as regards defining some common points of view, related to the accounting of the future leasing.

Both standards, mentioned above, take into consideration the residual value on establishing the elements of financial leasing contracts. The explanation relies on the fact that, beside the leasing rates, the residual value signifies a potential outcome from the cash flow of a user. The residual value represents “the real or market value estimated for the asset taken over leasing regime, at the end of contract” [Achim, 2005, p. 137]. The residual value should not be confused with the value of recovering, which signifies “the estimated value of a fixed asset, at the end of its standardized lifetime” [Constantinescu, 2006, 133]. One should emphasize that, in contradistinction to the international standards that make a separation of guaranteed and not guaranteed residual value, the Romanian standards do not accomplish such delimitation.

As concerns the lessor, the guaranteed residual value is, according to IAS 17, that part of residual value that is ensured by the lessee or a third part, not affiliated to the lessor, which is able as regards the financial point of view, to meet the obligations assumed by guarantee. Regarding the lessee, the residual guaranteed value is that part of the residual value which is guaranteed by the lessee or a part affiliated to this. The value of guarantee is established by the maximum value payable in any situation. Guaranteeing the residual value from the lessee point of view is relying on a premise, according to which the leasing object will be supported in optimal conditions; in this way, on concluding the leasing contract, the value at which this might be capitalized on market exceeds the guaranteed residual value. The lessor is directly interested of this issue, since depending upon the attention offered to the level of supporting the leasing object, the lessor will be duly remunerated by a percentage, which for instance in Germany is up to 75% of the difference resulted between the market capitalization price and the contractual residual value [Molico, Wunder, 2003, 80].

The lessee should recognize into the accountancy the leasing transactions, because contrariwise, the economic resources and the level of company's obligations might be under-evaluated, and the financial indices might be distorted.

The lessee should also admit the financial leasing operations within the accountancy, as assets and debts, at a value equal with the fair value of the good leasing regime or with the value updated of the minimal payments on leasing, in case this is lower. Using the updated value within accountancy represents an accountancy application of the money present value, application often met to Anglo-Saxon practice.

The assets taken in financial leasing regime are recognized by the lessees within the classification of assets, because they meet the criteria of recognizing foreseen within International Financial Reporting Standards. The assets taken in financial leasing regime appear as result of concluding the leasing contract, being susceptible on bringing future economic advantages, under the form of profit, and these advantages are evaluated in a credible way. For a lessee, carrying out an investment is justified, since the benefits are calculated so that they should cover at least the level of leasing payments.

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.

The revenues recognized by a lessee, as related to leasing activity, are represented by the revenues achieved from the asset's exploitation. In conditions where a lessee supports the costs of insurance, he will also recognize revenues resulted from claim damages, which might occur when the guaranteed risk is produced.

Concerning the recognizance of expenditures involved by the financial leasing operation, as related to current accountancy of the lessee, these are mainly represented by the financial expenses of the leasing rate of interest, the expenses of the asset amortization, the expenses of maintenance and reparations of the asset, as well as the expenses of the asset insurance, if the insurance is made on the lessee's name. The expenses of asset amortization come from the economic ownership, which a lessee can have over the asset, by dint of which the asset will be absorbed, in a way corresponding to producing the economic benefits resulted from its exploitation.

For instance, one can assume a financial contract, by which a lessee takes on 01.03.N, in leasing regime, a vehicle from a lessor, for duration of four years. The fair value of the vehicle is of 90 000 RON. At the moment of concluding the deed, one will assume that the lessor paid an amount of advance money of 18 000 RON. The rate of interest foreseen by the contract will be of 10%. The residual value guaranteed by the lessee will be of 14 000 RON. The value of minimal payments on leasing is established at 19 000 RON. The payments occur annually, at the end of each the leasing durations. The useful lifetime of the asset taken over in leasing regime is of five years. One will going to determine the minimal payments of leasing, and the yearly amortization of the asset taken in financial leasing regime.

In order to establish the entry values of the asset taken in leasing, one should calculate the updated value of the minimal leasing payments. The minimal leasing payments are represented by those payments over the contract duration, which the lessee should make, excluding the contingent rent, the costs of services and the taxes that the lessor will pay and which will be reimbursed to him, together with any amounts guaranteed by the lessee or a part affiliated to the lessee. In accordance to paragraph 12 of IAS 17, for the calculation of updated values on minimal payments of leasing, the implicit rate of interest on leasing contract is considered as updating factor, if this can be determined. Contrariwise, the marginal rate of interest of the lessee is used.

For the given example, the updating rate is calculated by means of rate of interest foreseen by the contract (10%). Subsequently, the updating value of the minimal leasing payments is defined by:

$$18\,000 + \frac{19\,000}{(1+10\%)} + \frac{19\,000}{(1+10\%)^2} + \frac{19\,000}{(1+10\%)^3} + \frac{19\,000}{(1+10\%)^4} + \frac{14\,000}{(1+10\%)^4} = 87\,790$$

One might notice that updated value of the minimal leasing payments is lower than the fair value. In these conditions, the updated value of the leasing payments will become the entry value of the asset taken by financial leasing.

The situation of minimal leasing payments can be depicted in Table no. 1. The calculations were done by using the method of rates of interest on balance on current account, which betakes the rate of updating, used by a user in order to determine the updated value of minimal leasing payments.

*Table no. 1 Situation of minimal leasing payments*

<b>Date of payment</b>	<b>Due</b>	<b>Rate of interest</b>	<b>Reducing the debt</b>	<b>Due capital</b>
(1)	(2)	(3) = 10% x (5)	(4) = (2) – (3)	(5)
03.01.N	18 000	-	18 000	87 790
03.01.N+1	19 000	6 979	12 021	69 790
03.01.N+2	19 000	5 777	13 223	57 769
03.01.N+3	19 000	4 454	14 546	44 546
03.01.N+4	19 000	3 000	16 000	30 000
03.01.N+4 Guaranteed residual value	14 000	-	14 000	14 000
Total	108 000	20 210	87 790	-

The amortization policy on assets in leasing regime has to be consequent to that applied to tangible assets, in ownership. In the given example, since there is no certitude on transferring the ownership right to the lessee, the amortization will be accomplished as sooner as possible, meaning in a duration between the leasing term (of four years) and the useful lifetime period (of five years). In this way, the term under amortization is of four years. The value under amortization is given by the difference between the entry value of an asset and the guaranteed residual value. By applying the method of yearly amortization, the following results are achieved:

Value that is going to be under amortization =  $87\,790 - 14\,000 = 73\,790$  RON

Yearly amortization =  $73\,790 / 4 = 18\,447,5$  RON.

At the end of leasing term, as regards the asset sending back, one might notice a physical wear of the asset over the foreseen level, as result of its utilization on the highest parameters. In these conditions and upon the basis of an expertise, a value of sending back will be established, lower than the guaranteed residual value. The lessee will pay to the lessor the difference between guaranteed residual value and the value of sending back. As concerns the accountancy of the lessee, this difference is registered as supplementary exploitation expenses.

One will assume that, as concerns the illustrated example, the transfer of asset's ownership to lessee at the end of leasing term, at the value of guaranteed value. In this way, the term under amortization will be given by the useful lifetime of the asset (of five years). The value under amortization will be given by the value of entry into the patrimony, meaning 87 790 RON. Given the new conditions, the yearly amortization will be of 17 558 RON.

Comparing the data achieved, one might see that a lower yearly amortization is achieved, as regards the transfer of ownership right towards the possibility of sending back the asset at the end of leasing term.

### 3. APPROACH THE AMORTIZATION IN THE MOMENT OF ASSETS REEVALUATION TAKEN OVER IN FINANCIAL LEASING

Relying on the economical ownership right, the assets of financial leasing regime are part of the lessee's patrimony. Being included within the class of tangible assets, they are submitted to reevaluation, in the same way as the other tangible assets of the same class, meaning those of identical type and utilization.

Reevaluation of the tangible assets consists in generally on replacing the net accounting value of the asset with its fair value. This value is determined upon basis of some evaluations, performed usually by authorized evaluators. When no possibility exists, so as to identify the fair value, because the reevaluated asset is very rarely sold, the asset will be evaluated at the cost of replacing reduced with the corresponding amortization.

Taking into consideration the British accountancy, two alternatives of reevaluation are possible [Cotlet, 2007, 233]. In accordance to the first alternative, the operation of reevaluation affects the profit by the size of additive amortization until the moment of reevaluation, and the difference resulted from reevaluation affects only the value surplus that exceeds the amortization. In this way, the profit should reflect the situation that might occur, if no amortization is calculated. In accordance to the second alternative, the fact that amortization part is for allocating the cost of reevaluated assets is taken into consideration, during their useful lifetime. Considering that reevaluated assets are not new assets, the reevaluation reserves will be affected by the difference between the reevaluated value and the net value of the

reevaluated assets. Choosing between the two types of solutions creates conditions of dissimulation on real situation, by reducing and respectively by increasing the achieved profit.

In accordance to paragraph 32 of IAS 16 “Tangible assets”, the frequency of reevaluations depends upon the progress of fair value on tangible assets. If the fair value is significantly modified, yearly reevaluation will be imposed. In the situation when the fair value is not significantly modified, reevaluation between 3-5 years.

IAS 16 offers two methods, by which the additive amortization on reevaluation time can be treated. A method consists in recalculation of amortization, proportionally to the gross accounting value of the asset; in this way, after the reevaluation, the accounting value of the assets will be equal to its reevaluated value. This method is used in the situation when the asset is reevaluated, by applying a coefficient resulted from the report berth the reevaluated value and the net accounting value of the transportation mean. The second method assumes the elimination of amortization from the gross accounting value of the asset, thus accomplishing by the reevaluation of net accounting value.

Starting from data of the example illustrated, one can assume that after two years from taking over the asset in financial leasing regime, and after the reevaluation, an fair value of the asset is established, meaning of 91 000 RON. In this situation, the main data of the issue are represented by:

- amortization accumulated in the last two years is of 36 895 RON;
- the net accounting value is of 50 895 RON (87 790 RON – 36 895 RON);
- the fair value is higher than the net accounting value, thus resulting an asset increasing of 40 105 RON.

Forwards, the results generated by applying the two methods of reevaluation accepted by IAS 16 are illustrated.

The methodology of reevaluation, by recalculating the amortization proportionally to the gross accounting value of the asset, which assumes the following two steps:

- calculating the report between the fair value and the net accounting value:  $91\ 000 / 50\ 895 = 1,788$ ;
- reevaluation of the input value and the amortization accumulated by applying the coefficient of increasing, of 1,788:
  - the reevaluated input value:  $87\ 790 \times 1,788 = 156\ 968$  RON;
  - the reevaluated amortization accumulated:  $36\ 895 \times 1,788 = 65\ 968$  RON;
  - net accounting value:  $156\ 968 - 65\ 968 = 91\ 000$  RON.

The data resulted by applying the reevaluation method is based on gross values and is depicted in Table no. 2.

*Table no. 2 Reevaluation based on gross accounting values*

<b>Explanations</b>	<b>Situation before reevaluation</b>	<b>Situation after reevaluation</b>
Gross accounting value	87 790	156 968
Accumulated amortization	36 895	65 968
Net accounting value	50 895	91 000
Reserve of reevaluation	-	40 105

The methodology of assets reevaluation on financial leasing regime, by eliminating the accumulated amortization from the gross accounting value can be depicted in Table no. 3.

Table no. 3 Reevaluation based on net values

Explanations	Situation before reevaluation	Situation after reevaluation
Gross accounting value	87 790	91 000
Accumulated amortization	36 895	-
Net accounting value	50 895	91 000
Reserve of reevaluation	-	40 105

Within the illustrated example, one might see that asset accounting value in financial leasing regime has increased. This value increasing has as result the increase of own capital, on classification of reevaluation reserves.

During the leasing contract, two reevaluations can occur. Depending upon the level that a positive reevaluation compensates a negative reevaluation of the same asset, previously accounted to expenses, the positive reevaluation should be accounted to revenues.

When the accounting value of an asset is reduced, as result of a reevaluation, the entire value of the depreciation will be accounted to expenses. This affirmation is valid only if no positive reevaluation has been previously established, which could generate the establishment of a reevaluation reserve. In conditions where negative reevaluations occur after a positive reevaluation, previously accounted, this will be treated as a reducing of reevaluation reserve, with the minimum between the value of that reserve and the value of reducing; the potential difference remained not covered is registered as expenses.

#### 4. EFFECTS OF CHANGES SPECIFIC TO ACCOUNTANCY ESTIMATIONS PERFORMED BY THE LESSEE

The international standard IAS 8 "Accountancy politics, changes in accounting estimations and errors" emphasize on paragraph 5 that changes on accounting estimations result from information or new evolutions, and subsequently do not represent corrections of the errors. Forwards, the effects of accounting changes performed by the lessee will be outlined, as regards the useful lifetime of the assets on financial leasing regime.

The lessee has to estimate the useful lifetime of each tangible asset. If the lifetime of an asset is significantly higher than the lifetime for which a company wishes to use an asset, then real advantages used in the favor of leasing will exist, as comparing to the situation of buying an asset. The main factors that affect the determination of useful lifetime of an asset are: utilization, physical state and the moral usage. The useful lifetime of an asset should be revised periodically by the lessee, in order to be sure that initial estimation as regards an asset is still available. The revising should be accounted as being a modification of accounting estimations. Such change of accounting estimation will have as result the adjustment of expenses, with the amortization on current period and for the future periods of time. Any changing of accountancy estimation should not have repercussions over the accounting data of the previous financial exercises, but they should affect only the current financial exercise and the future financial exercises.

In order to emphasize the effect of changing the useful lifetime of an asset being on financial leasing regime, one can add that by a leasing contract, the transfer of ownership right is outlined at the end of leasing term. One can also remind that the duration of leasing contract is of four years, and the useful lifetime estimated by the lessee is of five years. The method of amortization used is that linear. Since the certitude that an asset is transferred to lessee at the end of the leasing term exists, the asset will be under amortization during the

estimated useful lifetime. Subsequently, the yearly amortization is recognized at the value of  $87\,790 / 5 = 17\,558$  RON.

At the end of year N+2, and as result of performing some repairs expenses, which have significantly improved the performances of the vehicle under discussion, the lessee will see that the lifetime will be higher than that initially estimated. The new estimated duration is of nine years. In years N+3 up to N+8, the recalculated value under amortization will be determined as a difference between the value of entry and the amortization accumulated in years N, N+1 and N+2. The resulted value will be linearly shared in the next six years remained from the reevaluated lifetime of the asset. As result, the following results were calculated and will be outlined:

- accumulated amortization =  $17\,558 \times 3 = 52\,674$  RON;
- recalculated value under amortization =  $87\,790 - 52\,674 = 35\,116$  RON;
- yearly amortization (in years N + 3 up to N + 8) =  $35\,116 / 6 = 5\,852,66$  RON.

The new value of the yearly amortization of 5 852,66 RON will be forwards admitted, as an irreversible depreciation of the immovable asset on the next six years. One might notice a significant decrease on yearly amortization, calculated in accordance to the modification of useful lifetime, on the asset in financial leasing regime. The new value of the regime is equitably established, depending upon the time duration, when benefits resulted from using the assets will be generated.

## 5. CONCLUSIONS

The leasing represents an instrument of financing the investments, on mean and long terms, which has proven to be very efficient, both on national and international transactions. By the leasing system, the lessee disposes of an asset on high technology, both at the level of world techniques, by an advantageous mode of payment. The leasing system favors the concentration of resources over the profitable activities, by protecting the capital.

As regards the lessee, the financial leasing determines on one hand an tangible asset, whose value determines some expenses with the amortization of immovable capital; on the other hand, a loan is determined, whose value has to be reimbursed during the duration of leasing contract, thus generating both the payment of leasing rates and their specific payment of rates of interest.

Considering the lessee accountancy point of view, the amortization of the asset taken by financial leasing is determined differently, depending upon mentioning or not in the leasing contract about the transfer of asset ownership right, at the end of leasing term. Depending upon this contractual stipulation, the term of amortization and the value under amortization will be established.

The way of approaching the amortization in the moment of assets reevaluation on financial leasing term is framed within the alternative accounting treatments, thus being a consequence of accountancy politics, established by the manager of economic entity, in accordance to the accounting standards.

The lessee can perform changes on accounting estimations, as concerns the useful lifetime of an asset, if and only the financial leasing contract stipulates the transfer of ownership right at the end of the leasing term. The revision of estimation, regarding the useful lifetime has as result the changing of amortization, registered by the lessee, starting with the financial exercise, where revision, and in consequence, the changing of lessee's results are carried out.



The leasing, as instrument of investments and financing, can be framed within the circuit of globalization tendencies on world economy level, and subsequently, will open new views concerning future development and improving.

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