ACCOUNTING POLICIES AND PROFESSIONAL JUDGMENT APPLICATION OF IFRS 16 "LEASING CONTRACTS"

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Abstract: *IFRS 16 "Leases" is the result of the joint effort of the International Accounting Standards Board (IASB) by the US National Standards Standardizer, the Financial Accounting Standards Board (FASB), to improve financial reporting on leasing activities. The two accounting standards normators found that the reported information on operating leases was not transparent and the existence of different accounting models for operational and financial leases reduced comparability for users of financial statements. In addition, the different accounting of financial leasing from operational leasing 'provides opportunities to structure transactions to obtain a certain accounting result'* (Basis for conclusions in IFRS *16, BC 3). In these circumstances, IAS 17 'Leasing' has been replaced by IFRS 16 'Leases' and applies from financial year 2019. IFRS 16 "Leases" makes significant changes to the accounting for the lessee's leases and the information to be disclosed in the notes to the financial statements. To facilitate its understanding and application, IFRS 16 "Leases" is accompanied by application guidance and illustrative examples. The Ministry of Finance also created the legal framework for the uniform application of the standard by introducing specific accounting accounts in the General Accounts Plan annex to the Accounting Regulations în accordance with International Financial Reporting Standards, approved by Order of the Minister of Public Finance no. 2844/2016, with subsequent amendments and completions. Leasing accounting has been and remains a sensitive area in which professional accountants must exercise their professional judgment in order to assure users of information that the presentation of the items in the Statement of Financial Position / Balance Sheet and the profit and loss account has been made taking into account the fund economic nature of the transaction or commitment in question and not only the legal form of the lease. In the following, we intend to highlight how the application of the provisions of IFRS 16 "Leases" affects the Statement of Financial Position and the profit and loss account for entities that have the quality of lessee in a leasing contract.*

Keyword: *financial lease, operational leasing, lessee, lessor, right of use assets of leased assets, support assets, depreciation, interest.*
JEL Classification: *M 41.*

1. Application of IFRS in Romania

The issuance of accounting rules for the application of IFRS is the responsibility of the regulatory authorities, namely the Ministry of Finance, the National Bank of Romania and the Financial Supervisory Authority.

In the following we will refer to the application of IFRS by economic operators represented by entities whose securities are traded on a regulated market and some companies and companies with full or majority state capital included in the list annexed to the O.M.F.P. no. 666/2015 on the application of accounting regulations in accordance with International Financial Reporting Standards by certain state-owned entities (Official Gazette of Romania, Part I, no. 442/22 June 2015).

Entities whose securities are traded on a regulated market apply IFRS from the financial year 2012, while companies and companies wholly or majority-owned by the state apply IFRS from the financial year 2018.

Although the number of entities applying IFRS is small compared to the total number of entities (less than 100 entities), they account for a significant share of total net assets in the national economy, some of them operating in strategic areas (transport, electricity, oil, gas).

Due to the need to provide users with information that is as complete and comparable as possible, entities develop accounting policies under IFRS and apply them consistently from period to period.

Until 31 December 2018, the provisions of IAS 17 "Leasing" together with some interpretations were applicable for lease accounting (IFRIC 4 ”Determining whether an arrangement contains a lease”, SIC 15 ”Operating leases – incentives”, SIC 27 ”Evaluating the substance of transactions involving the legal form of a lease”).

From the financial year 2019 onwards, the accounting and disclosure of leases is performed in accordance with IFRS 16.

2. Novelty items brought by IFRS 16

a) Redefining the objective of the standard

The objective of IAS 17 is limited to "prescribing, for lessees and lessors, the accounting policies to be disclosed in respect of leases” (IAS 17 par. 1).

IFRS 16 prescribes principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a way that accurately represents those transactions" (IFRS 16 par. 1).

IFRS 16 also requires entities to consider all available information when accounting for a lease.

b) Revision of the definition of leasing contract

IAS 17 defined a lease as "an arrangement whereby the lessor grants to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time" (IAS 17 par. 4).

IFRS 16 states that "a contract is, or contains, a lease if that contract grants the right to control the use of an identified asset or for a specified period of time in exchange for consideration" (IFRS 16 par. 9).

Compared to IAS 17, we see two new conditions, namely that the user has control and that the asset is identified.

Control of an asset during the term of the contract means that the entity (lessee) obtains all the benefits from the use of the asset and has control over its use. In terms of „asset identification”, contracts must specify the asset whose use is transferred to another entity by providing specific identification data.

In relation to control of the asset, the analysis should consider the terms and conditions of the contract to see whether the supplier has a real right to substitute the asset (e.g. to replace it with a similar one) or to benefit economically from its right of substitution.

Depending on whether these conditions (existence of control and identified asset) are met, a contract will be classified as a lease (if it meets the conditions) or a rental contract and accounted for accordingly.

c) The existence of exemptions from the recognition provisions for leases in the standard.

Exemptions from the recognition provisions are optional and relate to short-term leases and leases where the asset has a low value.

A short-term lease is a lease that, "at the commencement date, has a term of 12 months or less" (IFRS 16 BC 93).

To assess whether an asset has a low value, the analysis is carried out both in terms of the individual value of the asset and in terms of how it is used, i.e. whether it is used independently of other assets.

The IASB has decided that if an underlying asset is highly dependent on, or closely related to, other underlying assets, a lessee need not apply the exemption from the recognition requirements for the lease of that individual asset" (IFRS 16 BC 102).

To qualify for recognition as a "low value asset", the IASB considered "underlying assets with a value, when new, of the order of $5,000" (IFRS 16 BC 100). By way of example, the standard stipulates that tablets, telephones and furniture can be treated as low-value assets.

For short-term leases and leases for which the underlying asset has a low value, IFRS 16 states that "the lessee shall recognise lease payments associated with such leases as an expense, using either a straight-line basis over the lease term or another systematic basis" (IFRS 16 par. 6).

In practice, contracts may contain various clauses for the protection of rights in the assets whose use is transferred. The examples accompanying IFRS 16 (examples 1-11) set out the terms (conditions) of some contracts and comments on their classification in relation to the criteria for recognition as leases or rentals.

d) Classification of leasing contracts

For lessees, the classification of leases as operating or finance leases is important from a legal point of view, as the contract sets out the rights and obligations of the parties.

IFRS 16 deals with the classification of leases in the section on lessors. Depending on the classification made, lessors will account for leases differently for the two categories of leases. In principle, accounting for operating leases and finance leases with the lessor under IFRS 16 is consistent with the accounting model in IAS 17.

Whether a contract is classified as an operating or finance lease depends on the substance of the transaction rather than the form of the contract" (IFRS 16 par. 63). The Standard sets out "examples of situations which, individually or in combination, may usually lead to a lease being classified as a finance lease."

A contract that transfers all the risks and rewards of ownership of an underlying asset is classified as a finance lease. A contract that does not transfer substantially all the risks and rewards associated with an underlying asset will be classified as an operating lease.

e) Accounting for leasing contracts to the lessee

To account for a lease, the lessee must review the terms of the lease to see if it contains one or more lease and non-lease components.

Non-lease components are accounted for in accordance with other standards, such as IFRS 15 „Revenue from Contracts with Customers”.

If there is more than one lease component and non-lease component, the lessee shall estimate the value of each component based on the individual selling price and allocate the lease payments accordingly.

IFRS 16 provides a single model for accounting for leases at the lessee level, and the classification of the lease as a finance lease or an operating lease has no accounting implications.

The standard defines new terms such as „right-of-use asset” and „underlying asset”.

Underlying asset is "an asset subject to a lease for which a lessor has granted the right to use that asset to a lessee" (IFRS 16 Appendix A Defined terms).

Right-of-use asset „means the right of a lessee to use an underlying asset during the lease term” (IFRS 16 Appendix A Defined terms).

The commencement date of a lease is „the date on which a lessor makes an underlying asset available for use by a lessee” (IFRS 16 Appendix A Defined terms).

A lease (operating or finance) will be accounted for in the accounts of a lessee by recognising, at the inception of the lease, an asset relating to the right to use the underlying asset and a related liability.

The asset relating to the right of use of the underlying asset is initially measured at cost. The liability recognised at the inception of the lease is measured at the present value of the lease payments outstanding at that date.

Assets related to the right of use of underlying assets measured at cost are depreciated and amortised, similar to the class of assets to which they relate (for example, the right of use of underlying assets of a technological equipment nature will be depreciated and amortised in accordance with the accounting policies approved by the entity for property, plant and equipment of this nature that it owns).

Depending on the terms of the contract, the right-of-use asset is depreciated:

- from the commencement of the lease term to the end of the useful life of the underlying asset, if the lessor transfers ownership of the underlying asset by the end of the lease term;
- from the commencement date until the earlier of the end of the useful life of the asset to which the right of use relates and the end of the lease term if the lessor does not transfer ownership of the underlying asset by the end of the lease term.

3. Subsequent measurement and disclosure in the annual financial statements of the right-of-use assets of the underlying assets and lease liabilities

Subsequent to initial recognition, the right-of-use assets of the underlying assets are measured using the cost model.

By exception, the lessee may apply the fair value model for right-of-use assets that meet the definition of investment property dealt with in IAS 40 „Investment Property” or the revaluation model if the right-of-use assets are associated with a class of property, plant and equipment to which the revaluation model applies.

Where the cost model is used, right-of-use assets are presented in the Statement of Financial Position at cost less accumulated depreciation and impairment losses shown, adjusted for any revaluations of the liability under the contract.

Liabilities under a lease shall be measured and disclosed in the Statement of Financial Position at an amount that reflects:

- the increase in the carrying amount by the interest associated with the lease liability;
- the decrease in the value of the liability with lease payments made;
- revaluation of the book value as a result of changes in leasing contracts.

The income statement shows the depreciation charge relating to the right of use of the underlying assets and the interest expense incurred during the year.

Underlying assets subject to a leasing contract are shown in off-balance sheet accounts.

Accounting for leases in accordance with the Accounting Regulations on individual annual financial statements and consolidated annual financial statements, approved by the Prime Minister's Order No 1802/2014, as amended and supplemented

According to these accounting regulations, the accounting model for leases is consistent with the provisions of IAS 17 respectively:

- in the case of finance leases, the lessee recognises in the accounts the asset subject to the lease and depreciates it;
- in the case of operating leases, the asset covered by the lease is recognised in the lessor's accounts. The lessee records periodic payments in the profit and loss account and leased assets in off-balance-sheet accounts.

4. Conclusions

The application of IFRS 16 from 2019 onwards has been a challenge both for staff in entities applying IFRS and for financial auditors and valuers performing the impairment test required by IAS 36 "Impairment of Assets".

Apparently, by establishing a single model for accounting for leases to lessees there is a simplification and better understanding of the information presented in the annual financial statements. In fact, the standard provides ample room for the exercise of professional judgement by those involved in lease accounting.

Issues such as the identification of a lease and its components, classification of leases, application of recognition exceptions, initial measurement and subsequent measurement of the underlying right-of-use asset and lease liability require professional judgement and estimates.

In order to meet the stated objective of ensuring "that lessees and lessors provide relevant information in a manner that accurately represents those transactions” (IFRS 16, part. 1), those involved in the process of preparing and presenting financial statements need to consider both the legal and economic substance of the transactions.

The transition to IFRS 16 by some entities applying IFRS has led to the reclassification of some long-term leases to leases and a change in their accounting.

In order to avoid the risk of reinterpretation or reclassification of contracts (from leases to rental contracts and vice versa), accounting professionals should take into account all information available at the date of classification and recognition of these contracts.

As the valuation of the underlying right-of-use asset and lease liability involves elements that are estimated (e.g. implicit interest rate, variable payments) it can sometimes be difficult to measure these elements in the annual financial statements.

References:

1. Accounting regulations in compliance with International Financial Reporting Standards by some state-owned entities, approved by Order of the Minister of Public Finance No 666/2015.

2. Accounting regulations in accordance with International Financial Reporting Standards, approved by Order of the Minister of Public Finance No. 2844/2016, with subsequent amendments and additions.

3. IAS 17 "Leasing", 2016. CECCAR.

4. IFRS 16 "Leases", 2017. CECCAR.