

Accounting for leases by lessee: Case Study

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ABSTRACT:

This paper aims to clarify the current deficiencies of lease accounting by lessees, to do so we focused on one of the Algerian enterprises as a case. The results refer to the fact that lease accounting requires attention because the current distinction between operating and finance lease is unrealistic and does not reflect the substance of transactions. We also have concluded that the adoption of a new accounting rule of leases will serve to make financial statements more accurate and transparent. Finally, developing accounting for leases can greatly benefit the users of financial statements since it creates access to the real accounting information which provides a complete and understandable picture of an enterprise's leasing activities.

Key words: Accounting for leases, IAS17 and SFAS13 standards, IFRS16 model, SCF regulation

JEL Codes: M40, M41

Introduction:

In the beginning, businesses often face high obstacles because of the inability to develop their activities, leading them to rely on traditional credit that is the most used debt financing method. But there are other alternative sources having also a high relevance or even more like leasing. In fact, it is a very suitable source

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and an efficient investment strategy confers on companies, intending to grow, the right to use property, capital equipment, and many other tangible assets without actually owning. Globally, the widespread leasing promoted several accounting bodies to propose adopting accounting standards explicitly for such transactions. As a result, the American Financial Accounting Standard Board (FASB) introduced the first lease accounting standard in 1976, known as the Statement of Financial Accounting Standards No. 13 (SFAS No.13-Lease). Years later, the International Accounting Standards Committee (IASC) developed the International Accounting Standard No 17 (IAS17-Lease).

These standards have been a hot topic to much debate between academics, preparers and users of financial statements. The main principle defect in these standards is that they are not compatible with the definitions of assets and liabilities in the conceptual framework (Mosnon, 2001). In 2004, The FASB and The International Accounting Standards Board (IASB) decided to work toward improving lease accounting standards. By 2016, a new accounting model for leases has been released called the International Financial Reporting Standard (IFRS 16, Leases) and the American Standard Codification (ASC 842 Leases) respectively.

In our country (Algeria), to support the pace development of the leasing industry, the state needs to develop and improve lease accounting requirements set out in local accounting regulation (SCF). In that regard, The Accounting National Board of Algeria (CNC) had been recently expressed its intention to start a reform of SCF, including revision of current lease accounting rules. Therefore, this article intends to analyze the current state of lease accounting by the lessee and enhance the awareness of the new International Financial Reporting Standard IFRS16 and its importance to achieve transparency to financial statements. Previous studies conducted qualitative research for examining disputes in lease accounting for example:

Arbidane and Puzule(2019) investigated the rationale for the valuation and accounting of the lease transactions in line with international accounting standards and identified problematic issues regarding their valuation and reporting in Latvia. In result, the authors have developed possible solutions for improving the quality of accounting for the lease transactions by proposing amendments to the legislation involving the necessity of applying new accounting based on IFRS16.

In (2006)Beattie et al conducted a questionnaire survey of U.K. users and preparers to assess their views on proposals for lease-accounting reform and on the potential economic consequences of their adoption. The results, based on 132 responses, found that both groups accept that there are deficiencies in the current rules. Another research by Bashir and Molla (2013) found that Changing the standard rent in Albania is considered necessary to achieve an increase comparability between companies and reduce the abuse of accounting rules

We follow this line of research, but with some important changes in the methodology, we use the case study approach as a type of qualitative research, with a focus on one of the Algerian Enterprises as a case (Transpac Enterprise).

To gain a detailed understanding of the research topic and to extract as much as relevant information, we have collected data from documents, i.e., directives, acts and decrees, as well as, the documents provided by the enterprise under study.

1. Theoretical background:

1.1 Previous accounting standards for leases

According to SFAS 13 and IAS 17 standards, a finance Lease is defined as a lease in which all risks and rewards are transferred to the owner of assets at the inception of the agreement, an operating lease is any lease other than a finance lease (IASB, 2003). Leases that does not meet risks and rewards test are accounted as operating leases, i.e. a finance lease is viewed as a purchase of an asset with financing, whereas operating lease is only a temporary rental of someone else's property (Bradburry, 2015). The capitalization of leases depends not only on risks and rewards test but also on other criteria set bellow, if one prevails, the leased item will appear on the balance sheet: (IASB, 2003)

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that;
- It is reasonably certain that the option of purchase will be exercised at the inception of the agreement;
- The lease term is the major part of the economic life of the leased item;
- Even if title is not transferred at the inception of the agreement, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;
- The leased asset are of a specialized nature only to lessee.

IAS17 standard avoids setting out quantitative thresholds unlike to SFAS 13 standard that adds- bright-lines classification tests as follows: (FASB, 1976)

- The lease term is equal to 75% or more of the estimated economic life of the leased item;
- The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased item to the lessor at the inception of the lease.

1.2 Shortcomings and Flaws of Previous Accounting Standards

Accounting for leases has created a constant debate since the expansion of IAS17 and SFAS13. As claimed by Branswijck, Longueville, & Everaert (2011) These standards have given more value to what is a finance lease contract while an operating lease was considered to be a lease other than a finance lease. Unfortunately, due to this flexibility in the concepts including classification criteria, creative lessees have been successful in finding a way to easily acquire financed assets and avoid recognizing them as assets and liabilities on the balance

sheet by manipulating lease accounting policies and violating the capitalization requirements (Nuryani, Heng, & Juliasta, 2015). Transactions were systematically structured around IAS 17 and SFAS 13 lease classification criteria to ensure the lease would be accounted for as an operating lease (Henderqon & O'brien, 2012).

Leasing, generally, provides firms with direct control over used asset (Agrawal, Ferguson, Toktay, & Thomas, 2012). The conceptual framework defined an asset as a resource controlled by the entity and a liability as a present obligation of the entity (Conceptual framework, 2016). The Group of Four plus One (G4+1) had emphasized that operating leases meet the conceptual framework definitions of assets and liabilities. Consequently, it should be recognized and included in the lessee's balance sheet (McGregor, 1996). The United States Securities and Exchange Commission SEC itself announced a document entitled "Off-Balance-Sheet Arrangements" showed that the accounting presentation of operating leases did not provide true visibility regarding the liability for future lease payments. Thus, it suggested that the FASB should undertake a project to reconsider the standards for accounting for leases and that project may be most effective if conducted as a joint project with the IASB board since it would be beneficial to have similar accounting standards be used around the world to the greatest extent (SEC, 2002).

1.3 Lease accounting convergence project:

In the context of ongoing collaboration between both IASB-FASB boards on the convergence of the United States Generally Accepted Accounting Principles (U.S.GAAP) with the International Financial Reporting Standards (IFRS), at a joint meeting held on 22 and 23 April 2004, the two boards addressed the importance to start a common accounting project for leases. The project has been given high-priority among all issues described in the Memorandum of Understanding (MoU). Initially, it was agreed that the reform should include both lessee and lessor accounting models, but they later opted to take an interest only in lessee accounting aspects. In 2016, a new accounting model for leases released, which both of the IAS 17-SFAS 13 have been canceled by replacing them with The International Financial Accounting Standards (IFRS 16) and the American Standard Codification (ASC 842) respectively.

1.4 The new standard IFRS 16 lease:

The new standard IFRS 16 became effective in January of 2019. Now there is no distinction between leases, no bright lines are made to avoid capitalization or to hide lease liabilities off the balance-sheet (Maglio, Rapone, & Rey, 2018). Lessee shall separate service from the lease and is required to recognize all leases as a right-to-use asset on the balance sheet, with all lease liabilities measuring by reference to an estimate of the lease term, which represents an obligation to pay. However, leases with a maximum possible term of 12 months or less, or for which the leased item is of low value when it is new, can remain off-balance sheet (PWC, 2016). Lessor accounting has not changed and still applies the requirements of The IAS 17 standard with the addition of new guidance on the definition of a lease arrangement, a sublease, and on the accounting for leaseback and sale transactions (PWC, 2018).

1.5 The difference between IFRS16 and ASC Topic 842:

Joint work on the lease standards had started in 2004 (As we have referred to before). Some comprehensive amendments have been made to previous requirements of IAS17 and SFAS13. The issuance timing of the lease standards was aligned. Both IASB and FASB board have completed work in the same year and have reached a converged solution about definition of a lease, measurement of liabilities (IFRS Foundation, 2016). However, there are a few distinct differences, IFRS 16 eliminated the dual classification of leases and replaced it with a single accounting model, while ASC topic 842 basically keeps the four classification criteria under SFAS No.13 and simply replaces the bright-line tests -based on specific numerical values- with qualitative parameters. In addition, the ASC topic 842 adds a fifth criterion that mandates lease capitalization for specialized assets that would have no alternative use to the lessor at the conclusion of the lease (BDO, 2019). Another relevant difference is the voluntary exception for low-value assets is not allowed in the ASC topic. 842(Diaz, Hermàndez, & Voicila, 2019).

1.6 Accounting for leases under the local accounting regulation SCF

During the implementation of the Algerian Accounting Regulation SCF project, leasing accounting has undergone some adjustments, which in turn changed the accounting treatment of lease arrangements. With the old accounting regulation (PCN) all leases were lacked capitalization, under SCF, finance leases are required to reflect the economic substance of transaction. In addition, the SCF allow for two different treatments on the financial statements: operating leases and capital leases. An operating lease as a rental agreement in which, lessor retains the ownership rights and responsibilities whereas the lessee merely uses the asset temporarily. In an operating lease, the lessee does not include the asset on the balance sheet. The periodic rental payments are reflected on the income statement as operating expenses. On the other hand, in a finance lease, the risks and rewards of ownership are transferred to the lessee, which recognize an asset at its fair value or at the present value of the minimum lease payments if the latter is lower and an obligation to pay future rents for the same amount on the liabilities side. So we can say that accounting for leases under SCF is based on the same requirement laid down in the IAS17 standard.

At present, The Algerian Accounting Board (CNC) is considering abandoning the current “Ownership” model and replacing it by a “right-of-use” approach under which the lessee recognizes an asset for its right to use the leased item and a liability for its obligation to pay for that item. In order, we would explain the main reason for that:

Firstly, all lease transactions should be recorded the same by enterprises since the non-cancelable, operating leases are really long-term debt finance, therefore, their recognition off balance-sheet would mislead users of financial statements. The second reason comes from the fact that operating leases are no less economically significant than finance leases, accordingly, differences in accounting practices of

lease can result in similar economic transactions being recorded differently, as well, some consequences may arise such structuring transactions, misallocation of capital...etc

2. Case study in TRANSPAC Enterprise:

In this section, we are trying to address the applied aspect of lease accounting practice by the lessee, to that we focused on Transpac enterprise which is located at Tlemcen, Algeria. Transpac is a middle size enterprise that has 53 employees working in different production and marketing units. Its management philosophy, its experience of 22 years in paper transformation activity and its sustained effort in the development of its products have as many levers of strength that distinguish it from its competitors and allow it to create a quality product sustainable for its customers.

The tables below summarize the general and financial information about the enterprise profile and determine its activities:

Table1. The general and financial information about the enterprise

Type of business	Producer
Trade register	02B0262864
Start of activity:	1999
Legal form	limited liability company (LLC)
Sector	Private
Total capital (2019)	41.868.370,49
Net result (2019)	+3.592.037,00

Table 2. Transpac activities

Products	Services
Coated Papers:	Processing of Paper and Cardboard.
Offset Coated Papers;	Cardboard Packaging.
Graphic Papers;	
Cardboard for printing;	
Roto-offset printing papers.	
Special Papers:	

Photographic Films;	
Sensitized Photo Papers;	
Color Boxes.	
Corrugated Paper and Cardboard:	
Rolls and Tubes of Paper of Cardboard.	

Source: Performed by authors based on the documents provided by enterprise

2.1 Leasing in TRANSPAC Enterprise:

Transpac had needed equipment for use in its activity. The enterprise has preferred to lease rather than to buy. Leasing is a widely used financing solution, as well as a significant source that provides the possibility to finance the purchase of fixed assets, by offering some supplements guarantees such as increased flexibility, tax advantages and improved risk-sharing. The case company concluded a lease contract (as a lessee) with the following main terms:

Table 03. Presenting the lease! contract concluding by Transpac Enterprise

Terms	Description
Leased asset	Equipment (Truck)
Lease inception	10/03/2017
Lease maturity	10/02/2021
Contract amount	2, 476,816.24DZD off tax
Lease payments	Fixed payments (Monthly) with an initial rental payment
Useful life	4years

Number of payments	Rent amount off-tax	Tax (TVA)
1	742,744.87DZD	141,121.53
47	46,821.82DZD	8,896.15

Source: Performed by authors based on documents provided by enterprise

2.2 The accounting treatment of lease contract by Transpac Enterprise:

2.2.1 Accounting treatment of lease contract:

Transpac enterprise has identified the type of lease at the date of inception as an operating lease for the following reasons:

- The lease term is not major portion of the useful life of the asset;
- The present value of lease payments does not make substantively all the fair value of the leased asset;
- The leased asset is not tailor-made for the lessee but is of general nature such that it can be leased out to another party by the lessor;

The enterprise recognized the lease as expenses on a straight-line basis over the lease term.

2.2.2 Journal entries by Transpac: since it is an operating lease accounting, the enterprise booked the rental expense per month as follows:

The initial journal entry at the inception of lease:

Account at 10/03/2017	Debit	Credit
lease rental	742,744DZD	
Bank		742,744DZD

Every 1st of the month Transpac pays the rental expense in this way:

Account	Debit	Credit
lease rental	46,821DZD	
Bank		46,821DZD

At the end of the first year 31/12/2017, the total rental payments involving initial rental payment was calculated as follows:

$$742,744.87 + (46,821.82 \times 9)$$

$$742,744.87 + 421,396.38 = 1,164,141.25\text{DZD}$$

Total rental payments of the 2nd and 3rd years 2018 / 2019

Amounted: 2018: $46,821.82 \times 12 = 561,861.84\text{DZD}$

Total rental payments of 2019 and 2020 is the same as 2018

The accounting entries in 2018, 2019 and 2020 continue in the same pattern.

2.2.3 Disclosure of lease contract in financial statements:

Transpac has applied the accounting treatment for operating lease accordingly to the SCF regulation. Lease payments were represented as expenses directly on the statement of profit or loss (income statement) for the year ending 31 December 2017, 2018, 2019.

It seems that Transpac uses leasing to increase its debt capacity without recording contract as an asset and liability on the balance sheet, it is completely intuitive because the Algerian Accounting Regulation (SCF) obligates all enterprises to recognize all lease arrangements which do not meet the criteria of classification as expenses on the income statement on a straight-line basis in case of the operating lease unless another systematic basis is more appropriate if payment to the lessor is not made on a straight-line basis.

2.3 Our analysis on this case:

Algerian Accounting Regulation (SCF) obligates all enterprises to recognize operating lease arrangements as expenses on the income statement that means, the assets that had been used by leasing were not shown on the statement of financial position. Therefore, any associated liabilities were also left out. When an enterprise reports a lease arrangement off-balance-sheet, in effect, it is making its liabilities low and unseen, thus distorting key reporting metrics such as gearing ratios, asset turnover, interest cover, EBITDA, EBIT, operating profit. This form of accounting did not faithfully represent the transaction because the company often effectively owned these assets and owed a liability.

The current state of practice requires the capitalization of all leases in order to take account of the substance of a transaction – that is economic reality rather than its legal form, In other words, the legal basis of a transaction may be used to mask the true nature of a transaction. By applying substance for all leases the financial statements become more reliable and ensure that the lease is faithfully represented.

Conclusion:

The present study allowed for a better understanding of the current state of leasing accounting practice. Currently, Finance leases are essentially treated like loans and require reporting on the balance sheet; while operating leases are basically handled like rent and contrarily are not reported as balance sheet items, the accounting treatment of operating leases that way is an abuse of accounting rules in reality. Otherwise, the new IFRS16 standard provides a unified accounting model to capitalize all leases. So, applying a new accounting for lease, inspired by it will bring a significant improvement over the current rules and addresses many of the inconsistencies plaguing. By eliminating classification tests and removing the distinction between finance and operating leases, transparency in financial statements will increase and greater consistency and comparability will be achieved

Further studies

Considering leasing accounting, it would be of interest for Algerian researchers to focus more on the following points:

Assessment of material benefits and challenges after applying a new accounting for lease in financial statements of Algerian enterprises

Paying attention to the estimated tax positions by Algerian Legislator concerning the implementation of a new accounting for lease

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