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FINANCIAL REPORTING AND TAX IMPLICATIONS OF REAL ESTATE LEASE

Finansijsko-izveštajne i poreske implikacije
lizinga nekretnina

Abstract

Leasing is a very popular way of acquiring fixed assets, but despite its importance and presence the users of financial statements are often not in a position to realistically consider reporting entity's lease transactions and their impact on entity's financial position and performance. For years, current financial reporting for leases has been subject to many critiques. The reason for this primary lies in the fact that it left a lot of opportunities for manipulation during the lease classification into finance and operating leases, whereby the former must be reported on balance sheet, and the latter remains off it. Bearing in mind that operating leases have favourable effects on lessee financial statements and a number of accounting ratios, the practice of lessee to deliberately structure lease contracts to circumvent capitalisation of requirements was noticed. Attempts to reform lease accounting have been intensified and their termination might be expected in a form of a new approach, which would be based on the "right of use" model, hence leading to reporting of almost all leases on balance sheet. Nevertheless, numerous dilemmas complicate the process of achieving comprehensive solutions. It should be considered that radical changes in lease accounting could have effects on lease taxation as well, particularly in the countries where stronger relationship between financial and tax reporting exists. It is also important to recognize the effect of a new approach to lease accounting from the sale and leaseback perspective. This transaction is particularly attractive in the conditions of economic crisis, primary because it enables companies to achieve liquid assets. However, if leases are classified into operating ones, favourable effects on financial reporting seller/lessee should not be neglected either.

Key words: *real estate lease, finance lease, operating lease, lease accounting limitations, right of use model, leasing taxation, sale and leaseback*

Sažetak

Lizing je veoma popularan način pribavljanja stalnih sredstava, ali uprkos njegovom značaju i zastupljenosti, korisnici finansijskih izveštaja često su u poziciji da ne mogu realno da sagledaju transakcije lizinga izveštajnog entiteta i njihov uticaj na njegovu finansijsku poziciju i performanse. Tekući tretman lizinga u finansijskim izveštajima je već godina-ma predmet brojnih kritika, pre svega zbog činjenice da je ostavio dosta manipulativnog prostora prilikom razvrstavanja lizinga na finansijski i operativni, pri čemu se finansijski lizing obuhvata u bilansu stanja, dok to nije slučaj sa operativnim. Imajući u vidu da postojeći računovodstveni tretman operativnog lizinga ima povoljne efekte na finansijske izveštaje i neke računovodstvene pokazatelje korisnika lizinga, uočena je praksa tendencioznog strukturiranja lizing ugovora, na način da se izbegnu zahtevi kapitalizacije. Napori na reformisanju računovodstva lizinga su intenzivirani, i moglo bi se očekivati da uskoro dobiju epilog u vidu novog pristupa, baziranog na modelu „prava korišćenja“ koji bi uslovio prikazivanje gotovo svih lizinga u bilansu stanja. Brojne dileme ipak otežavaju donošenje konačnih rešenja. Treba imati u vidu da bi radikalne promene u računovodstvu lizinga mogle imati uticaja i na poreski tretman lizinga, pogotovo u zemljama gde postoji čvršća veza između finansijskog i poreskog izveštavanja. Važno je sagledati i uticaj novog pristupa računovodstvu lizinga iz ugla transakcija prodaje i povratnog lizinga. Ova transakcija je veoma atraktivna u uslovima ekonomske krize, pre svega jer omogućava kompanijama da dođu do likvidnih sredstava, ali nije zanemarljiv ni njen povoljan uticaj na finansijske izveštaje prodavca/korisnika lizinga, ukoliko se lizing razvrsta kao operativni.

ključne reči: *lizing nekretnina, finansijski lizing, operativni lizing, ograničenja računovodstva lizinga, model prava korišćenja, poreske implikacije lizinga, prodaja i povratni lizing*

Introduction

Leasing represents a very significant way of financing business. According to the research conducted by Leaseurope¹, the share of European investment financed through leasing was 16% in 2008, while this share added up to 12% and 12.6% in 2009 and 2010 respectively. Preliminary results of the research for 2012 indicate that new leasing business in this year reached total value of €241 billion [10].

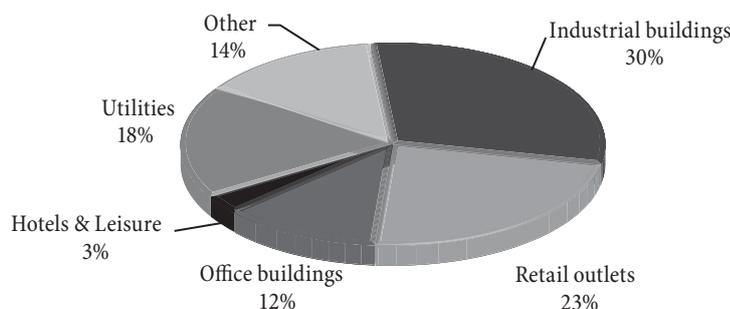
The segmentation of leasing market by asset types shows that in developed countries real estate is also often leased. Related statistics indicate that new real estate leasing volume in 2011 was €24.3 billion (the structure of these contracts by the real estate type is presented in Figure 1), whereas total outstanding leasing volume in 2011 reached €195.7 billion [11].

The popularity of real estate leasing was the result of its advantages when compared to other ways of financing. Leasing provides lessees with higher degree of flexibility in terms of responding to the changes in business surroundings, without making them limited by the ownership of assets, but rather giving them an opportunity to use free liquid assets that would otherwise remain limited on these positions. This way, the free liquid assets could be implemented in available and profitable projects that bear higher rate of return than interest rate that is kept in leasing, thus increasing the value of invested equity capital. Furthermore, leasing is a suitable source (and quite often the only one available) for financing the acquiring of fixed assets with newly established, small

and medium-sized enterprises (SMEs), as well as with all other potential clients with lower credit capacity.² A lessor keeps the ownership of the leased asset, which is another way that keeps him on a safe side. Therefore, a decision concerning financing is made not only based on the credit capacity of a client, but also on the degree of marketability of the leased asset. All this strongly makes an effect on the shortening of financing procedure and on the reduction of incurred transaction expenses. Thereby, a lessor is a specialized enterprise that can acquire the leased asset under favourable conditions and it can offer numerous services to a lessee: maintenance, servicing, technical and technological improvement, training staff of a lessee to use (properly) the leased asset etc.

The development of leasing led to its treatment in financial reports to be regulated by special International accounting standards (IAS), where the scope of leasing is based on “ownership” model and therefore a lease can be shown in balance sheet (financial lease) or it can remain off it (operating lease). Long-time implementation of this standard in practice led to worsening the quality of information in financial reports of lessees, because the criteria for lease classification are ignored and lease is inadequately presented as operating one, because in this manner the balancing of additional liabilities is avoided. In order to overcome this distortion created in the data, analysts usually resort to additional calculations and modify financial reports by treating all leases as financial ones. Practices like these ones unequivocally refer to inadequacy of previous way of lease reporting. For this reason, the

Figure 1: Share of new leasing volumes in 2011 by asset type



Source: [12, Fig. 10]

¹ Leaseurope brings together 44 member associations in 32 European countries representing the leasing, long term and/or short term automotive rental industries. It is estimated that Leaseurope represented approximately 92% of the European leasing market in 2011.

² Analysis of the lease use by SMEs showed that in 2010, 40% SMEs used lease and this was greater than their use of any other individual form of bank lending. The total amount of investment in fixed assets financed through lease was just over €100 billion [17].

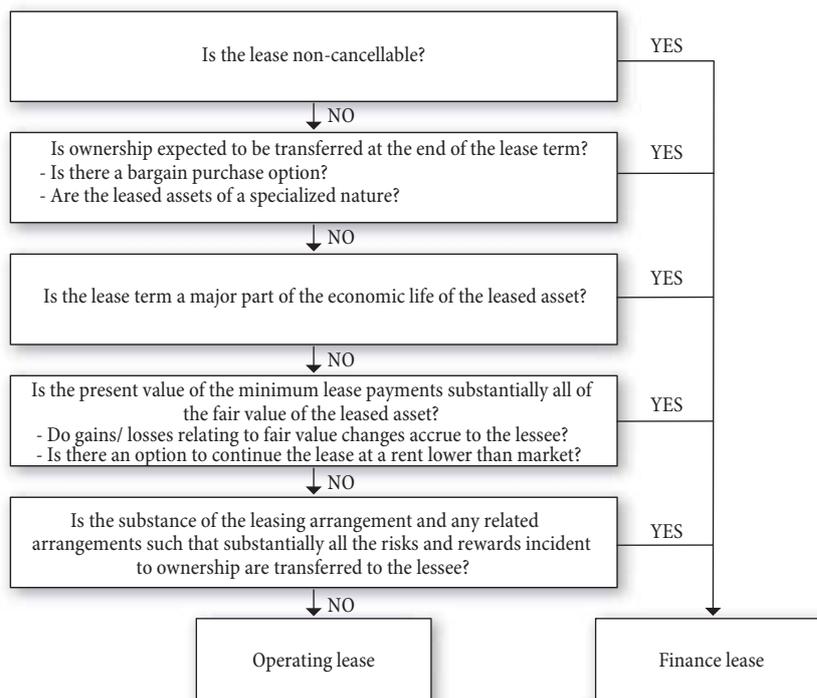
reform of lease accounting is in progress. One can expect that also operating lease (apart from short-term lease) will be included in requirements for lease capitalisation. The results of such a change will not be insignificant. According to the Pricewaterhouse Cooper’s benchmark study of a sample of approximately 3.000 listed companies it was shown that capitalisation of operating leases would lead to an average increase in entities’ interest-bearing debt of around 58%, the average increase in leverage (interest-bearing debt/equity) around 13% and the average increase in EBITDA around 18% [18].

Bearing in mind a current presence of these problems worldwide, as well as in Serbia, where in May, 2010 the law was passed which enabled real estate finance lease [24, Art. 4], this paper deals with financial reporting and tax implications of leasing and it is divided into several parts. In the first part we not only deal with ongoing requirements of financial reporting for leases, but also with related tax consequences. In the second part we analyse disadvantages of existing reporting model. In the third part we discuss possible directions and implications in the reform of lease accounting. The last part gives an insight into the attractiveness of sale and leaseback transactions.

Current reporting environment: Finance vs. operating lease

Accounting division of leases into finance and operating leases was primarily based on the scope within which benefits and burdens of the asset ownership, i.e. the leased asset, are transferred to a lessee. The term “burdens”, in this sense, means losses that may occur as a result of economic and technologic changes and unused capacities, whereas the term “benefits” is defined as the possibility of setting up profitable businesses during the useful life of assets and as capital gains made by the increase of assets value, or by sale of its residual value. Finance lease means that a lessor transfers to a lessee each and every burden and benefit related to the ownership, whereby the right of ownership, may or may not be transferred upon the expiry of the contact period. All remaining lease deals fall into operating leases. Although, when interpreting these definitions accounting regulation prefers substance of transaction to the form of the contract, different circumstances may lead to the same lease to be classified differently by the two parties. Nevertheless, certain situations unequivocally pinpoint to the substance of

Figure 2: Guidelines to classifying a lease



Source: [1, p. 599]

contractual relationship, hence to the lease type as well. The criteria for classification of lease contract in terms of accounting needs are shown in Figure 2.

In balance sheet of a finance lessee, an asset (real estate, building or land), which is the leased asset and also the liability on the basis of leasing, is recognized. Asset recognition comes as a consequence of the fact that in accounting, as a rule, substance is always put at the first place rather than form. Looking from the lease contract perspective, although a lessee does not have the legal ownership of the asset acquired this way, both accounting recognitions of an asset and related liabilities stem from economic ownership that enables a lessee to acquire the benefits gained by using the real estate and also requires taking over burdens related to the ownership; all this in exchange for the liability to pay for the right of use with the amount that is approximately even fair value of real estate which is increased by an adequate financial compensation.

The amount initially recognized for an asset or liability is even “fair value of the given real estate or the present value of the minimum lease payments accounts if it is lower” [16, paragraph 20]. The minimum lease payments are those payments that are made during the lease period, that are requested or can be requested by a lessee, and that are increased by residual value of the leased asset at the end of the lease term guaranteed by a lessee or a party related to him. The present value of the minimum lease payments is estimated by discounting a total expected payment amount on lease basis, whereby the discount rate is used as the interest rate included in lease, or incremental borrowing rate³, if the interest rate included in leasing cannot be certainly determined.

In most cases, minimum lease payments refer to a total amount that a lessee pays to a lessor during the lease term, and also to an amount that contains the value of the leased asset increased by the lease provision (interest). This means that the present value of the minimum lease instalments that is gained by applying interest rate included in leasing equals to the difference between total amount

given by a lessee and a lease interest, i.e. the present value of the minimum lease payments equals to the value of the leased asset at the beginning of lease term. If the value of the leased asset that is charged by a lessor equals to the fair value of the asset, the present value of minimum lease payments will be equal to the fair value of the asset, which unequivocally determines the amount for initial recognition of the leased asset in lessee's balances.

Both real estate taken via a finance lease and the liability on these basis are recognised under the same amount (except in the case when direct expenses of a lessee incur at the beginning). This means that the liability on the lease basis is presented by the amounts that do not include lease provisions (reimbursement or interest) that are calculated in advance. Furthermore, it should not be shown in balance sheets, but it is reflected in income statements in the periods when it incurs.

Given the fact that finance leases mean that the leased asset is recognized as an asset in a lessee's balance sheet, an expected consequence is the liability of a lessee to periodically depreciate the value of the leased asset that is charged with the depreciation expenses. Choosing the term that is going to serve as a basis for calculating the depreciation expenses (estimated economic life or the lease term) will depend on the criteria under which related leases were classified as finance leases.

If the lease contract includes the possibility of ownership transfer at the end of lease term, or if it contains the option to purchase real estate at the price that is lower than the fair value on the day when it is possible to take advantage of the option – Bargain Purchase Option (BPO), the real estate will be depreciated over the period that is the same as its estimated economic useful life. If the transaction is defined as a finance lease because of the fact that lease term is the same or almost the same as estimated useful economic life of the asset, or because of the fact that the present value of the minimum lease payments is greater or the same as the fair value of real estate at the beginning of lease term (under these criteria a transfer of ownership from a lessor to a lessee is not included), then period of depreciation is the same as the lease term or as the estimated useful life of the asset, depending on which one of these two periods is shorter. The difference

³ The incremental borrowing rate is the rate under which a lessee could make a similar lease arrangement, but if the interest rate could not be determined at the beginning of lease term, then it is the interest rate under which a lessee could borrow under the similar term and similar conditions with the aim to buy an asset that is the leased asset.

in accounting treatment is the consequence of the basis of transaction: in the first case a given real estate becomes the property of a lessee either upon the end of lease term or upon taking advantage of BPO; in the second case the owner remains a lessor.

The method of calculating expenses of depreciation for real estate that is acquired through finance leasing must be in accordance with the depreciation policies that a lessee applies to real estate that he already owns. The rule that an asset is written off only to the amount of estimated residual value is applied in this case as well.

The liability from guaranteed residual value, if it exists, is most often settled with additional payments at the end of lease term. The existence of guaranteed residual value, among other things, is motivated by the reason to decrease periodical leases on the basis of finance lease in the exchange for the payment of certain amounts, whose quantity depends on guaranteed residual value at the end of lease term. But despite it, the calculation of depreciation must be based on the base that is reduced by estimated residual value of real estate (not by residual value that is most often significantly greater than estimated residual value), what on the one hand provides a systematic allocation of costs incurred during the whole useful period (leasing) of assets, and on the other, disables presentation of high expenses (losses) incurred in the last period of lease duration, which are the consequence of the guarantee.

Periodical lease annuity that a lessee pays to a lessor must be divided into a component of liability reduction on lease basis and into a component of interest expense under the same basis, whereby the interest, from one period through the other, is calculated on outstanding debt. It should be noted that upon the initial asset and liability recognition on the finance lease basis in the same amount, the value of balanced real estate is annually reduced on the basis of depreciated expenses, while the value of liability is reduced by the amount of lease annuity that is reduced by corresponding annual interest. For this reason upon the initial recognition, these two positions will not have the same value in balances of a lessee any more.

If a real estate is acquired via operating lease, a lessee would not transfer the significant part of benefits and burdens that are the consequence of the ownership of

assets. As a result, that real estate will not be recognized as an asset in balances of a lessee. Although it is leased, it still serves as a position of balance sheet of a lessor, hence he amortises it, in accordance with his accounting policies, in a way which depreciates the remaining similar assets.

Accounting treatment under the operating lease is much simpler than the accounting treatment that would be applied if the same real estate was acquired via finance lease, in a case of classical lease, that is in Serbia regulated by the Law on Civil Obligations. Given the fact that, in the case of operating lease, there is no asset recognition in lessee's assets, the lease payments for related real estate are treated as expenses during the whole period of lease duration, on straight-line basis, if that kind of basis properly reflects the exact time when the cash flow of a lessee is incurred. If lease payments are determined on straight-line basis, which means that there are equal periodical payments during the lease contacts, the lease expenses will be recognized following the same principle.

Tax implications of real estate lease

As a rule, acquiring a real estate bears material tax consequences; therefore, tax planning of these transactions is a necessary precondition of maximizing tax savings. With real estate lease it is particularly important to consider tax implications in the scope of income tax, because they can be significantly different, depending on whether a lease is financial or operating one. Therefore, tax approach to lease is different in different countries.

The key question in terms of tax treatment of lease is who claims the tax benefits on the basis of the asset lease – whether it is the actual (legal) owner of assets, or economic owner. It is the fact that in tax laws it is very important to pay attention to the legal form of transaction, because it increases the legal support to taxpayers. For this reason, certain countries still prefer to relate the leased asset to a lessor. Nevertheless, there is a tendency to recognize the principle “substance over form” in the leasing case for tax purposes. This is especially characteristic in the countries where the influence of financial reporting on tax reporting is more present, but also in the countries where these two ways of reporting are largely independent (e.g.

the USA). Tax implications of leasing are primary based on economic reality, which means that judging is based on doctrines such as “economic substance”, “business purpose”, “substance over form” and “benefits and burdens of ownership”.

Although the situation in the EU is diverse⁴, current efforts of the member states to achieve harmonization of tax base of taxable income have a crucial importance. In 2011 a Draft Directive on a Common Consolidated Corporate Tax Base was proposed. In the draft it is clear that owner of an asset performs the depreciation, whereby an “economic” owner is defined as an entity “that basically bears all the benefits and burdens of the asset” [6, Art. 4]. It can be expected for this resolution to be recognized as benchmark that the member states should strive for.

Recognizing economic reality for tax purposes means that a lessee of finance lease, although he is not an asset owner, is able to use tax benefits from the acquired asset; these benefits are primary reflected in (accelerated) asset depreciation and in prospective tax credits on the basis of the investment that is made. Furthermore, the expenses of the interest that incur during financing from leasing are also recognised as reduced taxable income. As a result of decreased cash outflows of tax payments, all tax savings directly increase cash flows of an enterprise. The benefits of savings are even more increased because they are acquired earlier, therefore the accelerated depreciation and premature use of tax credits are significant stimulus for finance lease of assets and can greatly affect the making of investment decisions.

It is useful to mention that although a positive effect of accelerated depreciation on enterprise’s cash flows is indisputable, the effect will not be directly objectified in income statements and in the amounts of periodical results. Taxable income expenses incurred are not reported in the tax amounts that are paid by an enterprise in an accounting period, but they are reported by taking into account tax consequences of business activities recognized in financial statements. Tax savings on the basis of depreciation are then recognized bearing in mind the amounts of depreciation expenses in income statement.

⁴ To find out more about the tax treatment of leasing in certain Europe countries look at: [13].

Additional saving that is achieved with greater tax than accounting depreciation is neutralized later in useful life of assets, when the amounts of depreciation deduction are necessarily decreased (lower than accounting expenses of depreciation) due to the exhaustion of depreciation sum for tax purposes, what leads to greater tax payments. This means that accelerated depreciation leads only to current and not to definite tax saving and therefore its crucial effect is postponement of tax payments. Postponed tax payments in balance sheet are recognized as postponed tax liabilities, because this way the estimate of company’s future cash flows, to be more precise, cash outflows, in the basis of tax payments, is advanced. On the other hand, income tax expenses in balance sheet include deferred taxes as well, beside the tax amounts that are currently paid. The consequences of accelerated depreciation on the amount of periodic results and net cash flow are shown in Table 1.

Table 1: Integration of deferred taxes due to accelerated tax depreciation in income statement and cash flow statement

Income statement	Cash flow statement (indirect method)
Income tax expenses	Net profit after taxation
Current tax expenses	+ Deferred tax expenses
Postponement of tax payments does not lead to greater periodic result	Postponement of tax payments leads to greater net cash flow

Enabling accelerated depreciation as a way of investment incentives is somewhat criticised, firstly because of a possible suboptimal allocation of resources due to disavowing of market mechanism. For example, accelerated depreciation may lead to excessive investments in fixed assets with longer life and to insufficient investments with shorter life of fixed assets (because here the effects of incentives can be lost faster). The USA law on tax from 1981 allowed the depreciation of business facilities for the unbelievable short period of time of only 15 years, which resulted in excessive investments in this type of assets and “excessiveness that was overcome only after twenty years” [22, p. 673]. Nevertheless, accelerated depreciation is very present incentive and it is unlikely that it will not still exist.

Unlike accelerated depreciation, tax credits for investments in real estate lead to permanent tax savings and directly reduce the tax amounts that should be paid

rather than reducing tax base; therefore, they largely attract investors. While estimating benefits from tax credit it should be noticed that there may be limitations of amounts that can be currently used and therefore the transfer of unused amounts to future periods is performed. This way subsequent increase of cash flow (due to low tax payments) is postponed, and expected tax saving can be lost, if an enterprise does not make sufficient taxable income during the period that is determined for the transfer of unused credits.

Therefore, it's not strange when in certain cases a lessee is not able to use potential tax savings so he turns to making a lease arrangements where tax benefits are transferred to a lessor (the case in operating lease), while the portion of savings is transferred to a lessee via lower lease reimbursement.

In Serbia, accounting approach is mostly followed in tax balance and, accordingly, a lessee of finance lease is in a position to use depreciation deduction on the basis of a leased real state when calculating taxable income. However, tax credits are available only for the investment in fixed assets that are legally owned. A lessee is not the owner of an asset; therefore, he is not able to get a tax credit. This way, acquiring assets through finance lease is largely neglected and more expensive compared to alternative ways of financing (e.g. through credit).⁵

With operating lease the arrangement substance implies that depreciation deduction, as well as tax credits, belongs to the owner of lease asset, but a lessee has a right to reduce tax base by the amounts of lease expenses. When the amounts of lease instalments are the same, finance lease, with regard to operative one, lead to recognising high expenses that incurred during the first years of using assets (depreciation expenses, which are increased by instalment expenses, are greater than lease expenses), and low expenses that incurred later. The faster the asset depreciation is, the more noticeable this phenomenon is. In that sense, finance lease enables a lessee to achieve tax savings earlier.

⁵ This is particularly the case, bearing in mind that tax credits are not low. According to the newest amendments of the Law on Legal Entity Income Tax, enterprises can use tax credit when acquiring fixed assets with the sum of 20% of the investments that are made, even though the tax amounts for the given year can be lowered to up to 33% with this credit. For small business legal entity the percentages add up to 40 % and 70 % respectively [25, Art. 48].

The limitations of current reporting method on real estate acquired through lease

There is no doubt that the current accounting treatment of leasing has a large material defect that is the consequence of lease contract classification into capital and operating lease, and also of their fundamentally different treatment in financial reporting of a lessee. Real estate that is used by reporting entity when performing its business, and that is acquired through operating lease contract, may be seen from the data in the Notes to financial statements. Because of this:

1. financial reporting users neither can perceive the total asset volume that is used by an enterprise when performing its activities, nor do they obtain the information that says for what purposes assets acquired on the basis of operating lease contract serve, and
2. the liability to periodically pay for lease instalments that exists in the period that is, most frequently, longer than a year, is not presented in financial reporting and for this reason the users of financial reporting do not get the right insight into entity's credit worthiness.

Current accounting treatment of leasing is subject to many critiques of scientists as well as professionals, because it does not meet the needs of the financial reporting user, in the sense that it does not provide presentation of lease transactions the way it is. The asset of operating lease is not capitalized in balances of a lessee, although he gets certain benefits from it. This practice:

1. leads to inconsistency of this treatment with the definitions of assets and liabilities from Conceptual framework, and
2. does not give the overall picture of financial position of an entity to the finance reporting users because it omits to show the rights and liabilities that incur due to operating lease.

When we add to this the fact that, according to the S&P Compustat database, the share of operating lease in the total value of lease for the period 2000-2008 is 88%, which means that only 12% of all realized value of lease contract is presented in financial reports, the scope of

the problem becomes obvious. Information about the off-balance lease is being revealed in the Notes to the financial reports, which gives the opportunity to its users to independently perform capitalization with the aim of presenting the economic reality. However, collecting the necessary information and estimation of impact of off-balance lease, which is required for investment decision-making, can cause significant costs and involve high level of uncertainty. The situation may get worse if the information revealed in the Notes is incomplete, consequently causing a dramatic variation in the resulting estimates [21].

The existing criteria for lease classification are susceptible to manipulation; therefore, a lessee considerably takes advantage of this with the aim to classify the lease, which is capital in its substance, as operating one. Presenting operating instead of finance lease means that not only the latest debt in balance sheet is avoided, but also the increase of debt/equity ratio and decrease of interest coverage ratio with it. The perception of lessee's credit worthiness remains unimpaired, while the approach to latest debt remains simpler. The risk from violation of potential covenants in existing loan agreements is reduced. Lessees prefer lease presentation as operating lease also because they do not have to show real estate that is leased as a part of assets. While real estate that is leased contributes to generating income, its presentations in assets contribute to the growth of return on assets ratios.

Bearing in mind consequences from reporting operating versus capital lease, lessees are prone to structure lease transactions and contracts exactly in such a manner in which their classification into finance lease can be avoided.⁶ Small changes in transactions are very often sufficient to avoid capitalization.⁷ It is then possible that substantially same lease is differently treated by different

enterprises, considering their different appetites for off-balance financing, what further leads to the problems interfirm statement comparability.

Real estate lease most frequently contains two elements: land lease and facility lease that must be separately considered for the classification purposes. Given the fact that land very often has unlimited life, lease land classification will depend on whether the ownership of land will be transferred to a lessee until the termination of lease duration.

If the land and its important facility bear a different degree of burdens and benefits that come from the ownership, then they are divided into two leases and classified differently and, accordingly, they have a different balance treatment. On the one hand, the division of lease packages into constituent components and their separate accounting treatment and practice to arrange lease according to a rule define a unique lease instalment for a whole package and, on the other, make it necessary to divide minimum lease payments into two elements, proportional fair values of share of land and facility that are in lease.

Measuring fair value for these purposes should reflect unlimited life of land that does not lose its value during lease term, on the one hand, and limited life of buildings that are depreciated during a lease term, on the other. If it is not possible to determine fair value of one or two elements of lease, as similar land and facilities are not leased or sold separately, it would not be possible to surely allocate lease instalments on lease components. The liability to classify whole lease as finance one, in situations like these, represents an attempt to keep a lessee from treating a building lease as operating one, with the pretext that it is not possible to separately measure these two elements, although that is opposite to the transaction substance.

It seems that the largest number of opportunities for manipulation in terms of classification is provided by lease contracts by which the ownership of the leased asset is not transferred to a lessee, nor do they contain BPO. Lease arrangements like these ones require defining of materialistic importance of land shares in the total land property value, which is the leased asset, in order to determine whether it is necessary to decompose a

6 According to a recent study from 1980-2007, off balance sheet lease financing as a percentage of total debt increases 745%, while capital leases to total debt decreases 49.8%. In the study it was shown that finance and reporting implications of operating lease significantly contribute to the usage of this type of financing [7].

7 This is particularly emphasised when concrete numeric limitations for recognising lease as finance are set. For example, according to the USA GAAP, if the period of lease is over 75% of economic useful life of an asset, then we talk about finance lease, what implies that reducing the period of lease duration by several percents beneath 75% enables the lease treatment to be operating one.

lease. Even when it is obvious that the land shares are minor, the classification of the whole lease into capital or operating one requires judging which period of economic real estate life should a lease contract cover in order to be perceived as finance one, that is to say, which percent of real estate fair value a current value of minimum lease payment must have.

Although they are few in practice, these contracts in scientific literature are defined as “specific situations that cannot be found in the scope of IAS 17”; because of this their decomposition, in terms of classification, is largely susceptible to subjective judgement [19, p. 435].

In practice, quite frequently, one can come across lease contacts that have a portion of real estate as a subject, for instance, a lease of one or more floors of a business building, lease of stores within a shopping mall etc. The most common problem that may arise in the accounting treatment of these contracts is impossibility to determine a fair value of the real estate portion that is the leased asset in terms of objectiveness. In situations like these, an assessment of relationship between current value of minimum lease payments and fair value becomes irrelevant and therefore the only remaining and valid criterion under which it is possible to classify lease for accounting purposes is the relationship between lease term and economic life of the leased asset. Then, defining economic life of the leased asset implies the estimate of economic life of the whole real estate that consists of the leased rooms.

The complexity of lease contract classification, i.e. of its components, can be a powerful tool for shaping the appearance and contents of financial statements when used by skilful managers and accountants. If we start from the fact that real estate has a great individual value and that acquiring it through lease transaction has long-term liabilities as a consequence, manipulations in the scope of lease contract classifications can significantly change, in terms of materiality, the perspective of financial position of reporting entity. Eventually, the processes of convergence and constant improvement of financial reporting quality imply that it is necessary to remove defects of accounting treatment of lease transactions making it superfluous to mention that the current condition, in this scope, is not the one to last long.

Perspective of financial reporting on lease business

With the aim to overcome the limitations of currently valid accounting regulation that has the accounting treatment of lease contracts as its subject, in the last six years it can be seen that efforts of regulatory bodies (IASB and FASB) have been made. These efforts are focused on the project of the development of the new accounting lease model which should enable assets and liabilities, which are the consequence of the lease transaction, to be recognized in balance sheet, for the sake of increasing financial reporting value of use.

The solution for the problem on the uniform basis, is apparently not a trivial task because the propositions of a new standard draft that have been published are significantly different in the terms of not only the lease contract classification, but the repercussions on balance sheet as well. Nevertheless, today it is already certain that a new accounting standard on leasing will be based on the fundamental principle of the right of use (*right-of-use model*) which includes the measurement and recognition of the right of use of the leased asset, that is to say, the measurement and recognition of the transfer liabilities of the right of use the leased asset.

Given that the existing treatment of operating lease is labelled as cause of the financial reporting defects of the entities that have an important asset portfolio under the operating lease, the implementation of the solution will affect mostly the appearance and quality of their balances. Looking from the financial reporting perspective, operating lease will become equal to the capital one, what will result in a dramatic increase of assets and liabilities, while the amounts before tax, interest and depreciation (EBITDA – Earnings before interest, tax, depreciation and amortization) will also be increased because straight-line lease expenses that are current will be turned into the increased expenses of depreciation and interests.

Debt ratio in the overall capital, interest ratio, return on assets rate (ROA – Return on Assets) and other indicators, will largely succumb to these changes, while the comparability of these ratio numbers, when

compared to the previous periods, will significantly be impaired [3, p. 63].

Looking from a lessee perspective, but within the concept of the right of use, each lease contract of long-term nature⁸ will have the same treatment in the reporting on financial position, regardless the degree of burdens and benefits of the leased asset ownership that a lessee is exposed to. On the day when a lease term begins, a lessee, in the asset balance sheet, recognizes the asset that represents his right to use the leased asset during the lease term, while at the same time in liabilities balance sheet he recognizes the lease payments liability. By counting current value of lease payments, the initial value of assets can be reached.

For the purposes of initial and additional measurement, lease payments represent a relatively complex category that may include: lease instalments, potential leases, guaranteed residual value, contractual penalties that are paid by a lessee, and the price by which BPO may be realized⁹. Lease instalments, as periodic lease payments that are related to the flow of time, are most frequently exactly determined by a contract itself. Potential leases are lease payments whose appearance and quantity are related to future activities. A lessee will estimate the sum of lease payments on the basis of potential leases that are related to the movements of certain indexes or rates, using reliable data on the future rates, that is to say, indexes, that are available, but if they are not available, the estimate will be made on the basis of current, dominating rates, i.e. indexes. The sum of lease payments on the basis of guaranteed residual value will depend on how large are the differences between guaranteed residual value and expected residual value that the leased asset will have upon the termination of the lease term. The payment expectations on the basis of contractual penalties will depend on the likelihood of the occurrence of certain factors that will cause the penalties to incur.

⁸ Lease that at the date of commencement of the lease, has a maximum possible lease term, including any options to renew or extend, of 12 months or more.

⁹ In the moment when a lessee has used BPO, lease relationship is terminated and a lessee buys an asset that was the leased asset up to that moment. Looking from that perspective, it is debatable whether the payment on the basis of BPO should be included into lease payments.

Therefore, the structure and the sum of overall lease payments may have several different outcomes. In addition, it seems that a consensus about lease payment structure has not been reached yet within regulatory bodies.

Although it is abundantly clear that almost all lease contracts will find a reflection in a report on financial position, their effect on income statement has not yet been crystallized. One of the possible solutions may be that a lessee performs a straight-line depreciation of the asset that he recognizes in asset balance sheet on the basis of lease relationship, from the beginning of lease term until the termination of it, that is to say until the termination of useful life of the leased asset (if this date comes earlier). Beside the expenses of amortisation, on the basis of lease contract, in income statement interest expenses are calculated on outstanding debt. This structure of expenses that are the consequence of leasing, would cause the appearance of greater expenses in the first years of the lease term, whereby the burdens of income statement would later decrease relatively with the decrease of debt principal.

Contrary to the possibility of a unique accounting treatment in income statement, there is a solution “on a plate” that would cause a different effect on income statement depending on the type of lease arrangement [5]. This approach comes from the classification of lease contract on the basis of two criteria:

1. the economic life-span of the asset that is covered by a lease contract, and
2. the relationship between current value of fixed lease payments and fair value of the asset that is the subject of a lease contract.

In regard to this, the largest number of contracts on real estate lease (the contracts that do not cover most of the economic life of real estate or the current value of fixed lease payments is significantly lower than real estate fair value) would cause the depreciation liability of real estate acquired through leasing, together with lease interest, to be recognized on the straight-line base in income statements within the scope of operating expenses (lease expenses); a lease payment liability would decrease during every additional measurement according to the effective interest rate method, whereas the asset would be progressively written off in the amounts that are equal to

the difference between straight-line lease and calculated interest (that is decreased from one period to the other due to the fact that it should be calculated on the debt outstanding). The treatment of expenses on the basis of lease is similar to the existing accounting treatment of operating lease through income statement.

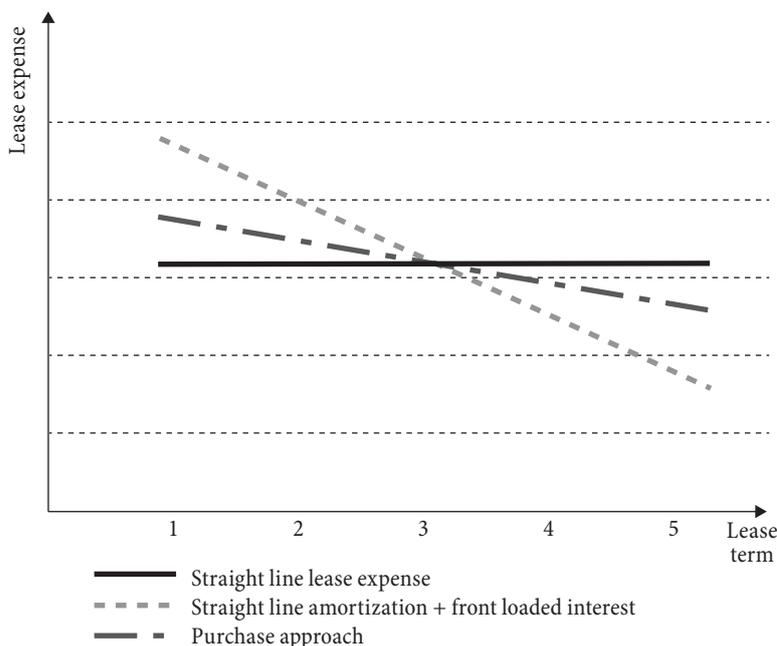
Otherwise, if a lease term is for the major part of the economic life of real estate, or the present value of fixed lease payments accounts for substantially all of the real estate fair value, the effect on income statement would be significantly different. The expenses of the asset depreciation (the right of use) would appear separately from the calculated interest and would be calculated through a method that shows the pattern of real estate use. This would have as its consequence profiling of expenses on the basis of lease contract in the way that is close to the expenses, which would exist in income statement if the given real estate was acquired by purchasing, and purchasing financed through a debt. A graphic illustration of the effects of the above-mentioned approaches on the income statements is presented in Figure 3.

Apart from already discussed dilemmas, another stumbling block in the establishment of professional regulation in the field of lease accounting is whether the right of use of real estate, that is the leased asset contract,

will be classified as material or immaterial property. A crucial consequence of implementation of the right of use principle, that dominates the latest lease accounting model, is that a lessee, on the basis of lease transaction, recognizes an asset that does not reflect a material position that is owned by an entity, but an asset that is reflected in the right of use of material position that he does not own, but on the basis of which he will achieve future economic benefits. With regard to this, during the lease term, a lessee recognizes and evaluates the right of use of real estate that is the leased asset and not just real estate. This raises a question whether a new standard on lease will refer to IAS 38 that signs an accounting treatment of material property, or IAS 16 that regulates balances of real estate, existence and equipment, and whether real estate that is the leased asset will be presented within the Immaterial property position, or within corresponding group of assets from the class of Real estate, existence and equipment, but separately from that group assets that are owned by a lessee.

It is not less important whether a new scope for accounting lease will eventually allow the possibility to exclude short-term lease contracts from the described rules for recognition and evaluation that rest on the right of use principle. If the professional regulation allows this

Figure 3: The effect of different approaches to accounting treatment of lease expenses on income statement



Source: [13, p. 21]

option, opportunities for manipulation of off-balance financing that exist due to the valid accounting treatment of operating lease will be narrowed, but will not disappear.

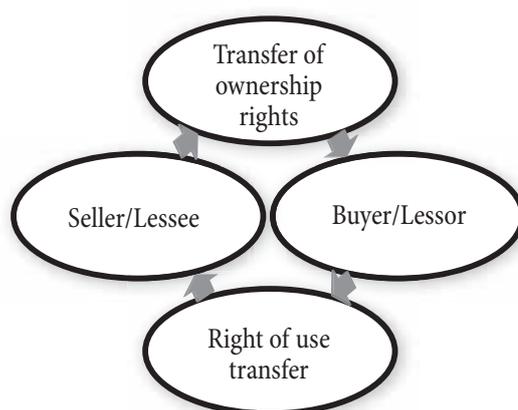
Scientists and professionals expect that in new professional lease regulation a problem of setting a clear line between purchase transactions and lease businesses will be solved. Setting this line will not be simple, because there are firm arguments that lease contracts that most commonly measure the control over the subject of real estate, as well as ownership burdens and benefits, are treated as sale (purchase). In other words, it is not wrong to consider the lease contracts that include automatic transfer of ownership of the given real estate upon the termination of lease period, as well as contracts that contain an option of the purchase of real estate by price, that is expected to be significantly lower than fair value of real estate (BPO) on the day when it is possible to use the option, what creates a huge likelihood, at the beginning of a lease term, that the option will be used as a way to sell real estate [9, Appendix B]. It remains only to be decided in what way the expenses will be accounted and when they are going to be recognized on the basis of this kind of real estate sale, given the fact that the dynamics of payments does not have to coincide with the pattern that is followed in order to transfer the burdens and benefits of the ownership. With this, a new challenge has been set for accounting. The challenge consists of making a clear distinction between lease and sale transaction, and of establishing an accounting treatment that would normally maintain the differences that stem from their economic substance.

Sales transactions and real estate leaseback characteristics

Looking from the point of view of the effects made on profit-making capability and financial position of an enterprise, the most interesting real estate lease type is the transaction where an entity sells real estate to the other entity and leases it at the same time. This business is structured from two economically different transactions that do not bear a physical transfer of an asset, the subject to the business, as its consequence. The way this business is structured is presented in Figure 4.

The trend of sale and leaseback started with occasional transactions in the mid 1990s, while the scope of these transactions was increased nine times only few years later (1998-2002) [2]. The frequency of this phenomenon increasingly coincides with the development of real estate market, which had as its consequence an intensive development of specialized institutions, dealing with the making of real estate portfolios that are made with the aim of leasing and selling real estate, on the one hand, and increasingly stringent requirements of financial institutions during the process of long-term lease granting, on the other [15]. Professional real estate management by specialized houses (lease companies and different funds) has led to increasingly higher number of entities that opt for the option to be lessees rather than real estate owners. Therefore, lessees are willing to pay higher lease instalments in the exchange for professional service, lower expenses, and risk reduction. At the same time, due to the economy of scale, these institutions are able to offer real estate lease

Figure 4: Sale and leaseback



requirements, based on the interest rates that are mostly more favourable than those of financial institutions [23].

Sale and leaseback transactions are different from direct lease when it comes to several important elements [8]:

1. Direct lease means acquiring real estate that an entity did not use up to that moment, while through sale and lease back, an entity sells real estate that he has already used, and at the same time he continues to use it on the basis of lease contract which states the use period and reimbursement.
2. In practice quite frequently (among everything else, as a measure of enterprise recovery) it happens that the subject of sale and leaseback is real estate portfolio combined with other assets (most commonly equipment and facilities related to the real estate), what makes these transactions financially larger and more complex than direct lease.
3. In sale and leaseback contracts it is typical that a new owner takes over the responsibility related to the management and risks related to real estate.
4. An entity that appears as a seller/lessee in this transaction, obtains a compensation for real estate sold, in the amount that is the same as current market price, keeping the right of real estate use in its own business at the same time.

Characteristics of sale and leaseback point to close similarity with long-term financing, which is why this business is, in both theory and practice, presented as a perfect substitute for a long-term debt. This statement is true, if all ownership burdens and benefits are transferred to a lessee through lease contract, what is the case only in finance lease arrangements. With operating lease, a buyer/lessor keeps the ownership burdens and benefits, while seller/lessee eliminates real estate from his balances, but does not terminate to use it while performing his own activities, thereby ensuring a long-term off-balance financing. Existing projects of the development of financial reporting standards in USA and Europe, point out that the possibility like this one (not presenting liabilities on the basis of external financing) will be available for short period of time. Certain research shows that the market gives positive and statistically significant signals, reflected in share price, to sale and leaseback arrangements, while

on the other hand that kind of effect during the emission of the new circle of activities or additional borrowing does not exist or it is even negative [20]. For that reason it would be better to say that classical borrowing and sale with leaseback are complementary ways of financing, rather than substitutes.

Sale of real estate and lease of the same asset necessarily leads to objectifying of latent reserves that are part of underestimated carrying value of real estate [4]. The share prices most frequently do not reflect the real asset value of an entity, due to informational asymmetry that exists between a manager and investor. This problem is particularly expressed in real estate example, given the fact that it is difficult for investors to estimate the value this type of asset based on financial reporting. The use of historical expenses principle with real estate leads to making significant exceptions between carrying value and current market price. As time passes, this distortion becomes even bigger, causing the appearance of secret reserves. This is why their realization through real estate sale also implies a positive response of market to sale and leaseback transactions.

By capital release achieved through real estate sale, entities reach a significant volume of liquid assets, which then may be invested in profitable projects related to the basic activity, which increases rate of return on invested capital. If the same real estate is leased at the same time, a diversification of financing sources is then performed, because the use of previously sold real estate is financed through real estate market, and not through financing market. When we add to this potentially favourable tax effects, the advantages of this type of transaction appear to be apparent.

Tax motives for carrying out sale and leaseback can be very significant, even crucial for performing this transaction. For an example, land is immobility which is characterized by unlimited life, for this reason the expenses of depreciation cannot be recognized for neither financial reporting purposes, nor for tax purposes. Nevertheless, if the land is leased, and land lease is most frequently treated is as operating lease, then the amount of lease imbursement is not counted while determining taxable income. Thereby, the sale of land may lead to the presentation of capital

income, which is the taxable subject, but that tax can be significantly surpassed by future tax savings, thanks to the leases that will reduce tax base.

Tax benefits may be apparent with sale and re-lease of building facilities. For an example, if an enterprise has capital losses with which a possibility of further transfer in advance is easily reduced, making it possible for an enterprise to lose tax savings related to it, then the sale of real estate by which an enterprise could obtain capital gains, appears as the way to prevent tax benefits losses, i.e. to create “non-taxable” capital gains thanks to setting them off against capital gains. On the other hand, if an enterprise needs that real estate, then leaseback is ideal opportunity because it leaves a possibility of reducing taxable incomes to an enterprise – either for lease imbursement with operating lease, or amortization expenses that are increased by the interest with capital lease. These expenses are even greater than depreciation deductions before the real estate sale, bearing in mind that secret reserves are being objectified by the sale.

If an enterprise is in an opposite situation, and it possesses impaired real estate, then a sale and leaseback could help the enterprise to speed up the presentation of related capital loss for tax purposes and therefore it could obtain tax saving earlier, i.e. to advance its cash flow. This is the result of the fact that the losses, due to the impairment, are not recognized for the tax purposes immediately after they have occurred, as it happens in financial reporting, but the recognition is delayed until the loss is objectified in market transaction.

Sale and leaseback transactions can be subject to denial by tax authorities. Therefore it is necessary to prove that there exists another business purpose, apart from avoiding tax, something like a lack of liquid assets and limited approach to the traditional sources of financing, at the same time.

Beside tax reasons, an additional motivation for exchanging the status of owner for the status of a lessee can be an increased efficacy through rationally using the capacity, through entrusting the organization and maintenance of the space to a new owner, who is specialized for this type of services. Entities increase flexibility in terms of reacting to the market changes by lease instead of possessing real estate because the ownership of real estate

sets certain limits in terms of size, type and location of facilities which, in the latest market circumstances, may not be suitable for fulfilling the aims in a competitive match.

It does not mean that there are no potential risks coming with sale and leaseback transaction. Seller/lessee of real estate may be forced, after the termination of lease contract, to negotiate the possibilities of prolonging the period of using real estate but under the new requirements which include a high risk of the lease price increase. If a buyer/lessor does not want to renew the lease contract, an entity will be forced to satisfy the need for real estate by reallocation, which is related to a large range of expenses and risks that may incur if an adequate real estate, which could completely enable a smooth business continuation is not found.

With the aim to prevent these situations from happening, entities quite often enter the lease contract that lasts really long, what further exposes them to additional risks of moral and economic obsolescence of real estate that, after some time, will not be able to meet the market requirement.

As much as it offers flexibility to entities, sale and leaseback transaction can limit it. Due to defined stringent penalties that are applied when one party decides to terminate the contract, entities are forced to use the real estate although it stopped to satisfy the needs if an entity in some aspects. One of the possible solutions could be to turn to modernization and structural alteration of real estate, what an entity will rarely opt for. Activities like these ones mean that there is a wide range of assets that are necessary for financing the renovation process that cannot be provided externally on the basis of real estate investment while on lease, but a mortgage must be placed in a different real estate that is owned by an entity. While renovation work and modernization are carried out, the activities of an entity in that segment are terminated. At the same time there is the liability of lease payments in the periods when the leased asset is not used at all.

Lease contracts which define fixed periodical amounts of lease instalments bear a risk of the decrease of market price of lease, for which reason entities, in these periods, would be forced to pay for the right of use the prices that are a way greater than market ones. Given the fact that the sale and leaseback are being negotiated together, the

important part of the stated risks can be improved by the sum of selling price, which will keep the award for these risks, or by defining more flexible conditions in terms of lease duration, or changes of lease instalments. The risk that entities will be exposed to after the professional regulations in the field have been changed, means eliminating the possibility to exchange real estate in balance sheet for cash equivalent, through sale and leaseback transactions in the form of operating lease, without expressing liabilities on the same basis. This way the appearance of these transactions is decreased, looking from the perspective of their effect on the appearance of financial reporting,

Accounting treatments of sale and leaseback will depend on whether the result of the transactions is financial or reporting lease. If the transactions results in financial leaseback, then we talk about the instrument of financing, whereby the given real estate represents the means through which this is fulfilled. For that reason, a possible difference that may occur between the sale price and carrying value of real estate cannot be recognized as the loss out of sale. Instead of it, the sum of difference includes the whole period of lease term and, and it amortises, that is recognises it as an income, uniformly in each and every period where the right of real estate use is realized.

The real estate sale that had operating lease as its result can have significant implications on how high the presented result is in the period when the transaction was carried out, but also on the results of accrued period when the real estate will be used. How great the result of this transaction is and its accounting treatment will depend on three elements: carrying values of real estate, fair value of real estate, and accomplished sale prices. Apart from this, important element that will determine accounting treatment of losses made from real estate sale is the sum of future lease payments. Bearing in mind that sale and leaseback are negotiating together, the low price of purchase transaction can have economic effects when defining lease instalments that are officially beneath the current market condition. For this reason, the losses made of real estate sale are considered to be compensated by low lease prices; therefore, they are not recognized in the moment of transaction, but they must be separated and

amortized in the period when the real estate will be the leased asset.

Conclusion

Overcoming numerous defects of existing accounting treatments of lease and increasing useful value of financial reports of an entity that has a wide range of assets on lease (especially on operating lease), represent invaluable contributions of the right of use concept as the base for a new accounting lease. The users of financial reports, who will no longer have to calculate the amounts in which entity's assets and liabilities are reported, will enjoy the largest number of benefits from the right picture of which asset volume an entity really uses and what are his liabilities on that basis. Nowadays, these activities are performed by financial analysts. In most cases, as a consequence, they have great expenses incurred by obtaining financial reporting information of a debatable reliability, because the interpretation of off-balance information from commonly poor Notes to the financial reports is based on the estimates and subjective judgement.

Each of the described solutions that could be found in a new standard on lease businesses has its advantages and disadvantages looking from the aspect of lease contract substances, separately. It is unquestionable that imposing liabilities to reporting entities in terms of rights and liabilities presentation from the lease contract in the report on financial position will enable uniform accounting treatment for most lease contracts, what will eventually increase the comparability of financial reports. The implementation of right of use model undoubtedly leads to higher quality measurement of the leased property, because in financial reports of a lessee the same real estate, or its portion, will be presented on different values, depending on whether a lease term covers smaller or greater part of its economic useful life.

Although operating lease as the type of business has its economic purpose, the existence of operating lease accounting will be secured in the moment when a new lease reporting model is introduced in near future. Therefore, it is necessary for entities, even now, to start preparing what would provide an easier implementation of new rules.

Updating accounting data bases on existing lease contracts would represent a step forward to a better understanding and analysis of consequences that would certainly be made on financial reports by the changes proposed. Also, the trainings provided for the professional staff, which should use a new Standard while dealing with the transactions from accounting perspective, appear to be incoherent factor when obtaining quality information. Collecting the data, setting up new calculation schemes for determining not only the amounts that will be capitalized but also the designs of software solutions; in this phase it will make it easier for entities to respond to, today already certain, radical changes with more flexibility. It is important to note that the changes in accounting approach to lease may lead to the changes in tax treatment of lease, particularly in those jurisdictions where the financial reporting is in conformity with tax reporting. As a result of this, an unavoidable analysis of related tax consequences arises. Looking from the perspective of a manager, this is a phase where advantages and disadvantages of alternative ways of real estate acquisition should be considered, while keeping up with the recent situation, and for the sake of future strategic decisions.

It is noteworthy to mention the possibility of real estate sale and leaseback, by which it can be overcome not only the problem of liquidity, but also a number of other strategic problems that enterprises are particularly exposed to in the conditions of current crisis. There are two effects that cannot be avoided. The first one is the improvement of financial report appearance, as well as the ratio of financing, profit-making capability and asset structure, through: eliminating parts of illiquid assets, and at the same time increasing the cash, that is to say the cash equivalents; dispersion of the financing sources, among which those that are part of operating lease are of off-balance character; objectifying hidden reserves that are part of real estate which are valued through the method of acquiring value; presentation of income obtained through the sale in current and future accrued periods; separating the losses that are realized and their periodical recognition in the periods when the real estate was used; eliminating the depreciation expenses etc.

The other effect is freeing the capital that could, afterwards, be invested in entity's profitable projects within the scope of its activity. If such projects exist, and if estimated return rate of these projects is higher than lease discount rate, then the sale and leaseback businesses may be the trigger for the increase of capital return rate, hence for the increase of market value of an enterprise as a whole.

Therefore, the analyses of further transactions development will be interesting after the new accounting treatment of lease transactions has been introduced, which will immediately treat certain contracts as sale, while the others, those that had the treatment of operating lease arrangements, will significantly decrease positive repercussions of the above-mentioned effects that arise during the first year. The development of future events will reveal basic motifs for undertaking sale and leaseback businesses in large scope during the past decade and will lead to the conclusions whether entities use these businesses as an instrument of shaping a financial report, or as businesses with economic purpose, which expect additional values to arise.

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