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# Lease Accounting Methodology: A Theoretical Reflection

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***Abstract:*** *The purpose of this paper is to examine lease accounting methods and x-ray how they influence a choice of lease arrangements. Requirements of International Accounting Standards (IAS) 17 were considered including theoretical framework on the various dimensions of leasing. From archival data, preference is given to operating leases as an off-statement of financial position financing. It also possesses few bottlenecks than finance leases in terms of compliance with accounting requirements. Consequently, it is essential to take cognisance of the complexities inherent in the respective lease options before deciding on which one to undertake. Moreover, the need to be computer literate as a result of growing trends in information and communication technology (ICT) is vital because most leasing arrangements presently, are perfected using sophisticated software.*
***Keywords:*** *Finance lease, operating lease, International Accounting Standards, information and communication technology (ICT).*

## I. Introduction

Leasing has for centuries been recognised as an important source of finance. It is a strategy for acquiring resources (in the form of machinery and equipment) for economic transformation of business enterprises. The consumers cut across various industrial sectors comprising financial institutions, oil and gas, manufacturing, aviation, energy and telecommunications. The conventional rationale for leasing is to reduce the risk of utilizing an asset by not actually owning it, thus giving the firm greater borrowing capacity (Fubara, 2004: 112). Globally, leasing has been recognized as an efficient financing method that can be utilized to facilitate capital formation process as more of the world's equipment needs are met through this unique form of financing.

In Africa, Nigeria remains a leading player in the leasing industry with N671 billion assets (Lawanson, 2014). Also David – Ikpe (2007: 22) while commending the Central Bank of Nigeria (CBN) governor for formulating the financial system strategy (FSS) 2020 which was designed to make Nigeria the financial hub of Africa by the year 2020 said:-

I want to mention here, particularly that in other parts of the world, for example in the United States, equipment acquisition through leasing consists about 30% and that is a significant number. Leasing was a critical source of finance and if adopted would help grow the nation's economy. It helps you to acquire an asset. These are the issues we have made very clear and we have said that if you take critical assessments at them, then Nigeria will become the financial hub of Africa by 2020.

In the USA, leasing provides more finance than the corporate bond and commercial mortgage markets put together. This is applicable in Western Europe where leasing has grown at a faster rate than any other forms of finance in the past 25 years (Gao, 1995: 32). Globally, the industry accounts for an annual turnover of about $750 billion and constitutes the largest external source of finance (Lawanson, 2014).

Scholars have documented studies on leasing in the past. Agundu and Mba (2005: 1-7) did a work on leasing business in Nigeria: operational issues and challenges. The study focused on the critical convictions and competitive factors of leading corporate concerns so as to spur others to keep going and growing through strategic change. It was found that modern investment appraisal methods were applicable and indeed imperative in lease financing decisions, if the meaningful rental economies that have been the feat of compliant firms are to be contracted by their counterparts. Robinson (1999: 177 – 182) examined commercial lease terms and the property cycle and found that the profitability of business units can be severely affected if the lease fundamentals, particularly the rent review mechanism are misunderstood.

Similarly, Metawa (1995: 6-17) while examining the evaluation of lease investment opportunities: a decision support methodology recommended the use of a decision-support methodology (a computer-based system devised to solve both structured and ill-structured problems, operations research and management science) by lessors as they conduct their lease investment evaluations in an environment characterized by strong competition, incomplete information and rapid technological advances rather than the traditional internal rate of return (IRR) and net present value (NPV) criteria.

These studies did not consider the methodologies adopted in accounting for leases. The present paper is aimed at closing this gap by theoretically examining the methodologies adopted in accounting for leases and how they influence a choice of various lease arrangements. The next section will dwell on theoretical framework. This will be followed by lease accounting methodologies, discussion of theoretic findings, conclusion and recommendations.

## II. Theoretical Framework

Leasing is an investment strategy which confers on a company the right to benefit from services of a capital asset without necessarily owning it. It is a contract whereby the owner of an asset (the lessor) grants to another party (the lessee) the exclusive right to use the asset in return for the payment of rent (Van Horne, 2002: 543 and Chandra, 2001: 561). Leasing falls into two main categories – finance (capital) lease and operating (service) lease.

A finance lease transfers substantially all the risks and rewards incidental to ownership (IAS 17). The lessee is obliged to pay such cost as insurance, maintenance and similar charges on the property. Usually, the agreement is non-cancelable and the lessee has the option to buy the asset for a nominal amount at the end of the lease term. The salient features of a finance lease are: it is an intermediate to long term non-cancelable arrangement; the lease is more or less fully amortised during the primary lease period; the lessee is responsible for maintenance, insurance and taxes and the lessee usually enjoys the option for renewing the lease for further periods at substantially reduced lease rentals (Chandra, 2001: 562).

An operating lease does not transfer substantially all the risks and rewards incidental to ownership (IAS 17). The salient features of an operating lease are: the lease term is significantly less than the economic life of the equipment; the lessee enjoys the right to terminate the lease at short notice without any significant penalty and the lessor usually provides the operating know-how and the related services and undertakes the responsibility of insuring and maintaining the asset. Such an operating lease is called a "wet lease". An operating lease where the lessee bears the costs of insuring and maintaining the leased equipment is called a "dry lease" (Chandra 2001: 562). Leasing could also take the form of a sale and lease back arrangement in which a firm sells an asset to another party and this party leases it back to the firm (Van Horne, 2002: 544).

Lease financing possesses some advantages. The rental expense is deductible and may include amortization of land and the value of buildings already substantially written off. In effect, the firm can sell the property at its true value and receive cash for investment in other purposes. There is an increase in the ability of a firm to source for funds. For instance, if the firm owns a piece of property and wishes to borrow, it may not obtain loan above 60% of the property worth, but in lease financing, it could source virtually 100%. Lease financing may be cheaper depending on the period over which property covered by the lease is amortised and upon the rate of interest approved for the lease when compared with the rate of interest for borrowing. The cost of obsolescence is also an additional expense if the asset is owned. Restrictions in loan agreements may be avoided by the use of leasing; this may be short-lived in view of the fact that leasing involves debt obligation (Fubara and Dappa, 2000). Capital allowances are granted on the asset where finance leases are involved. In most countries, leasing plays a vital role in economic transformation. In Poland for example, leasing has been used in effecting privatization of government owned corporations. The State leases companies to Polish entrepreneurs with no upfront capital being paid (except the initial down payment), but with payments being made periodically. Over time, the entrepreneurs can accumulate profit and buy the company. 385 Polish enterprises were privatized through leasing as at the end of the first quarter of 1992 (Frydman and Rapaczynski, 1993: 54).

Alternatively, some disadvantages confront leasing as a source of credit financing. The residual value of land and building revert to the owner; this condition may represent a significant loss during an inflationary period or due to the development of an area. The rental payment is a fixed obligation, just as interest on loan is a fixed obligation. Failure to recognize this fact may result in over-extension of commitments by a firm and in reorganization or bankruptcy. There may be less flexibility and adjustability to changing market conditions. If a firm owns its property, it may sell a piece of it, make additions to it or make adjustments which it might not be able to do under a lease arrangement (Fubara, 2004: 116).

Lease agreements could be international if they are perfected beyond national boundaries or local/domestic if they exist within the country of origin.

## III. Lease Accounting Methodology

The methodologies adopted for accounting for leases in the financial statement of lessor and lessee differ remarkable for finance and operating leases. The accounting methods are stipulated under International Accounting Standards (IAS) 17.

**Financial Statement of Lessee**

In the financial statement of lessee, finance leases are recognized as an asset and a liability at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments using the interest rate implicit in the lease or the lessee's incremental borrowing rate as the discount rate. Initial direct costs such as those associated with negotiating and securing lease arrangements form part of the cost of the asset.

The minimum lease payments are apportioned between the finance charge and the reduction of outstanding liability. The finance charges are written off as an expense during the period of the lease. Depreciation is applied on the leased asset based on the depreciation policy on similar assets owned by the lessee and written off as an expense during the lease period or, the shorter of the lease period and its useful life, if there is reasonable uncertainty that the lessee will obtain ownership of the asset at the end of the lease period.

In addition, the following disclosure requirements are imperative in financial statements: the net carrying amount at the end of the reporting period; a reconciliation between the total future minimum lease payments and their present value at the end of the reporting period, contingent rents and basis of determination, any subleases and related minimum sublease payments, renewal or purchase options and escalation clauses and restrictions imposed by the lease arrangement.

For operating leases, lease payments are recognized as an expense on a straight-line basis over the lease term. The following are required to be disclosed in the financial statements: the total future minimum lease payments under non-cancellable operating leases, total future minimum sublease payments expected to be received under description of lease arrangements and any restrictions imposed.

**Financial Statement of Lessor**

Finance leases are recognized as a receivable in the statement of financial position at an amount equal to the net investment in the lease (which is the aggregate of the minimum lease payments and any unguaranteed residual value accruable therefrom). The finance income is apportioned over the lease term on a systematic and rational basis reflecting a constant periodic return. Disclosure requirements for finance leases are: a reconciliation of the gross investment in the lease and the minimum lease payments receivable at the end of the period; the gross investment in the lease and the present value of the minimum lease payments at the end of the period; unearned finance income, unguaranteed residual value; contingent rents recognized as income in the period and the lessor's material leasing arrangements.

On the other hand, incomes from operating leases are recognized as income in the financial statements on a straight-line basis over the lease term. Costs incurred including depreciation are written off as an expense. The following are required to be disclosed in the financial statements: - future minimum lease payments, total contingent rents recognized as income and a description of lessor's leasing arrangements.

## IV. Discussion of Theoretic Findings

The accounting methods for the two categories of leases present different features. The recording of finance leases in the financial statement of lessee as both an asset and liability and associated apportionments meant that more expertise is required than accounting for operating leases, which merely involves the writing off of a rental payment as expense of the period. In addition, the reduction of the recognized liability component in a finance lease arrangement involves a segregation of the inbuilt finance charge from the amount required to liquidate the liability on a periodic basis. Moreover, the finance charge element has to be determined in a manner that produces consistent interest rate to be applied uniformly on the fair value of the leased asset.

Alternatively, accounting for finance leases in the financial statement of lessors simply involves the recognition of the leased asset as a receivable and the apportionment of the rental income systematically over the lease period. This same less burdensome approach applies to that of operating leases in the lessor's books in which the rental income is recognized in the financial statement on a straight-line basis to benefit the entire horizon covered by the lease. Costs incurred including depreciation are written off as expenses.

The scenario presented exposes finance lease accounting as possessing complexities than operating lease. The globalization of accounting practice through International Financial Reporting Standards (IFRS) and the emergence of Financial Reporting Council of Nigeria requires complete compliance with accounting procedures. Leasing as a specialized source of credit financing commands full compliance with accounting procedures. Undoubtedly, extensive accounting practices and the need to comply with legal requirements and accounting standards may influence the choice of lease arrangement to undertake. It may, therefore, be appropriate to engage in lease transactions with less complications especially, the accounting perspective. According to Watts and Zimmerman (1978), positive accounting theory maintains that when managers are confronted with a selection between accounting methods, they attempt to minimise any adverse "economic consequences" of accounting methods. Economic consequences represent differences in a company's cashflow arising from different accounting methods. The differences may occur as a result of debt contracts, management compensation contracts or regulatory requirements based on reported income statement or statement of financial position numbers. Even in situations where accounting methods are not optional, anecdotal evidence suggests that managers alter real decisions or actions to obtain their desired accounting result (Lipe 2001:299-310).

## V. Conclusion and Recommendations

The methods of accounting for leases present different challenges. It is more for finance than operating leases. This work exhumed the technicalities associated with reporting of leases in financial statements and clearly sets agenda for a selection of appropriate lease arrangement in view of the complexities involved.

A choice of a particular lease arrangement should take cognisance of the complexities involved and the need to comply with relevant accounting standards. A commentary on lease accounting research and the G4+1 proposal indicates that on the average, lessees prefer operating lease accounting (Lipe, 2001:299-310). As an off-statement of financial position financing, it does not expose an organization to any liability inherent in the lease and less cumbersome in terms of compliance with financial reporting requirements. This paper is significant as it enriches literature on leasing in a competitive and emerging economy like Nigeria. With the growing trend in information and communication technology (ICT), computer literacy is important in accounting and evaluating leases because a great number of lease transactions are currently implemented using appropriate software.

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