

THE LEASING AND THE PREVALENCE OF THE ECONOMIC DOMAIN OVER THE LEGAL DOMAIN

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Abstract

In present times, more and more companies resort to financing their capital through leasing. Leasing's popularity is understandable, because it offers great flexibility, often coupled with several economical advantages which arise from the right to ownership. Management's option for a rent contract or a lease contract is determined by its economical and financial strategies.

1. HISTORICAL PERSPECTIVES

The origins of leasing, albeit its archaic type, could be found in the Roman law, specifically in the fiduciary property. The fiducia is defined as a convention through which the person called the fiduciant transfers to another person called the fiducier the temporary property of certain goods.

The first operations in which leasing has its roots appeared at the end of the nineteenth century in the United States, where telephone machines were lent to subscribers with a contract named “lease.” Also in the US, in the context of an expanding economy and an encouraging economic climate, more and more companies realized that they could not deal with the demands using only their own production capacities. Because companies did not have enough cash to buy the necessary production capacities, the solution was to rent the necessary production equipment. Thus, companies specializing in renting production equipments were born. This prefigured a new industry, specifically the leasing operations industry.

All these types described above represented very simple forms of leasing. Leasing as a financing activity is closely linked to the Californian businessman Schoenfeld [1], who, along with some collaborators, founded in 1952 the *United States Leasing Corporation*, a company specialized in leasing movable equipment. Even today it is one of the most competitive companies in the leasing domain. Leasing was strongly supported by banks which financed leasing societies, and later banks became themselves authorized to perform such operations.

In the early 60s, leasing also became popular in Europe, first in Great Britain, and later in other Western European countries such as Germany, France, and the Netherlands. Both the name of the operation and its legal regulations were different from one country to another.

Leasing officially became an institution in 1972, with the birth of the European Federation of Leasing Company Associations (LEASEEUROPE), which controls over 80% of the European leasing industry.

In Romania, the leasing was first acknowledged and controlled through the Governmental Ordinance no. 51/1997 on leasing operations and leasing associations. Later, the legal context of leasing operations was enriched and perfected through other normative acts [2].

Currently, leasing is very popular; because of the way the contract is set up, a lot of flexibility is allowed in many situations, as well as many economical advantages are offered above and beyond those of legal nature.

2. LEASING BETWEEN LEGAL AND ECONOMICAL

Leasing can be defined both from a legal and an economical point of view.

From a legal perspective, leasing [3] is the operation through which one party called the lessor/financer transfers for a certain period of time the right to use a certain asset which he/she owns, to another party, called the lessee/user, at the latter's request, in exchange of periodical series of payments called leasing rate; at the end of the leasing period, the lessor/financer has to respect the user's right to choose to buy the asset, to extend the leasing contract, or to end all contractual relationships. The user can choose to buy the asset before the end of the leasing period, if both parties agree and if the user pays everything that was established in the contract.

As seen above, the leasing activity takes place according to the leasing contract. This type of contract is a lessor-type contract, and it contains specific aspects related to the object and the technique of carrying this operation. From a juridical perspective, the contract has the following characteristics:

- It is a synallagmatic contract because it yields correlated and interdependent obligations, both for the financer and the user. The financer's obligation is to insure the usage of the leasing object for the user, and the obligation of the lessee is to pay the leasing rate to the lessor.
- It is a burden-some contract because both parties have a patrimonial interest.
- It is a consensual contract, because the very manifestation of the parties' will is sufficient to form a valid understanding. For opposing a third party and under probatory circumstances, the written version is necessary.
- It is a commutative contract because the rights and obligations assumed do not depend on chance, but they are prescribed by the law and the contract between the two parties.
- It is a contract with successive execution because the right to use is transmitted for a finite period of time, and the leasing rate is paid periodically.

From an economical perspective, leasing is a source of financing, based on a specific contract (a leasing contract), in which the financer offers the necessary funds for the entire investment. Throughout the contractual period, the owner allows the renter to use the asset in exchange of the latter's promise to pay successive leasing rates. From an economical viewpoint, the right to use an asset is more important for the renter than the right to own the asset. In this case, the use and not the ownership of the asset are contributing to the owner's financial gain.

Between the two perspectives on leasing, the economical and juridical, the accounting field was forced to find the best solution to accurately reflect those transactions.

3. THE ACCOUNTING OF LEASING CONTRACTS

3.1. THE DEFINITION AND CLASIFICATION OF LEASING CONTRACTS

According to Leasing Contracts IAS 17, a leasing contract is an agreement through which the lessor conveys to the lessee, in exchange of a payment or series of payments, the right to use an asset for a set period of time. The leasing agreement can include several stipulations for adjusting the payments in response to construction or purchasing prices of the leased property, as well as stipulations for the lessee's choice to become the owner of the asset at the end of the contract. Other contracts which may resemble leasing contracts, such as rent-to-own contracts and so on, are considered part of leasing, given the encompassing area of this Standard [4].

The typology of leasing contracts developed by the IAS 17 is based on the extent to which the risks and advantages associated with ownership of an asset under leasing are of consequence to the lessor or to the lessee.

The risks include the possibility of losses as a result of low usage and moral usage of the asset, as well as a result of income variations due to economical climate changes.

The advantages result from a good estimation of profitable activities during the economical life-span of the asset, as well as from gains which result from increased value or residual value.

Relative to the criterion discussed above, there are two types of leasing contracts: the finance lease (lessor-financing contract) and the operating lease (simple lessor contract).

A finance lease [5] is a leasing contract which results in the transfer to the lessee of most of the risks and advantages inherently associated with the asset. At the end of the contract, the ownership of the asset may or may not be transferred to the user.

An operating lease is a leasing contract which is not a part of the financial leasing definition. In this case, the risks and advantages associated with the asset are not transferred to user (lessee).

In order to correctly reflect the transactions which take place, both for the lessor and for the lessee, it is important for both parties to correctly define the type of leasing contract they are agreeing on. When the leasing contract is defined, the substance of the contract and not its form should be a priority. To this end, IAS 17 offers example of situations and aspects, which taken separately or taken together, lead to defining a leasing contract as financial leasing.

Here are some examples of situations which lead to defining leasing as financial:

- The asset ownership title is transferred to the lessee until the end of the leasing period;
- The lessee has the option of buying the asset at a price which is low enough compared to the value of the object at the time when this option becomes available;
- In most part, the duration of the leasing contract covers the duration of the economical life of the asset, even if the title is not transferred;
- At the beginning of the leasing contract the up-to-date value of the minimum payments is at least equal to the full value of the asset in leasing;
- The leased assets are of such nature as only the lessee can use them without major changes.

Here are some aspects which, separately or taken together, can lead to classifying leasing as finance leasing:

- If the lessee is able to cancel the leasing contract, the lessor's losses associated with this become the responsibility of the lessee.
- The gains or losses resulted from variations of the true residual value are the responsibility of the lessee (for example, a reduction of the rent equivalent to the largest part of the selling profit at the end of the leasing contract), and
- The lessee has the right to continue leasing for a second period, at a rent rate which is significantly below the market rate.

Of the criteria discussed above, the first five are determined as natural, meaning if any of the criteria are met, the contract should be classified as financial. The last three criteria are more suggestive in nature, that's why the IAS 17 standard asserts that they could lead to classifying a contract as a financial contract.

Due to the theme of this paper, we will further refer only to finance contracts.

3.2. THE ACCOUNTING OF FINANCE LEASING IN THE LIGHT OF THE INTERNATIONAL REFERENTIALS

The accounting of leasing contracts is one of the best examples for the application of the principle of the economical prevalence over the juridical, as it is detailed in the general IASB guidelines for preparing and presenting financial situations.

The economical viewpoint requests that the asset is registered in the lessee's account, using his right to use and own the asset, thus being consistent with the above principle which requests that the transactions should be accounted in accordance with their economical substance and not only their legal form.

The legal viewpoint is largely different from the economical viewpoint because the asset is considered the property of those who offer the credit, and because of this it should be subsumed to the lessor, and not to the lessee, as it is in the economical field.

The accounting treatment of financial leasing operations in the context of the financial situations of the lessee

At the beginning of the contract, the lessee acknowledges the financial leasing operations as active financial situations and as debts at a starting value which is equal to the true value of the asset in leasing or with the updated value of the minimum leasing payments, if the latter is less.

The accounting treatment determines the recording of the leasing events and transactions in concordance with their economic substance and with the economic context, not only with their legal form. Although the legal form of a leasing contract reflects the fact that the lessee can not gain ownership of the leased asset, the substance of the finance contract is that the lessee gains the economical benefits of using the asset for most part of the economical life of the product, in exchange to having to pay a sum which is approximately equal to the true value of the asset at the beginning of the contract and the associated financial expenditures.

The finance payments are divided into two components: the financial expenditure (interest) and the liquidation of the remaining debt. The financial expenditure has to be made in time, over the leasing period, such that a periodical, constant rate of the interest is obtained, for each period, applicable to the remaining debt of the financial contract. In practical terms, to simplify computations, allotting financial expenditures between different aspects covered by the leasing contract can be approximated.

Aside from financial expenditures, finance leasing generates expenditures which contribute to the liquidation of the remaining debt. The liquidation of the leased assets is consistent with that of liquidable assets already owned. If there is uncertainty about the possibility that the lessee could own the asset at the end of the leasing period, the assets will be entirely liquidated for the duration of the leasing contract or the life-span of the object, whichever is shorter.

The accounting treatment of leasing finance leasing in the context of the financial situation of the lessor

The lessor's accounting, an asset which is owned in financial leasing is presented as an outstanding debt at a value which is equal to the net leasing investment. Because the lessor transmits to the lessee all the risks and advantages associated with owning the asset, the leasing rates charged by the lessor are treated as reimbursement of the

principal and as afferent source of income. The financial income is a debt income and represents the payment for the lessor's investment and services.

Parceling the financial income during the leasing contract can be made systematically and rationally, so that it reflects a periodical and constant rentability of the net investment which is not liquidated, according to the financial leasing.

3.3. THE ACCOUNTING OF FINANCE LEASING IN THE LIGHT OF THE NATIONAL REFERENTIALS

National regulations assert that "physical assets obtained as result of a leasing contract are recorded based on the nature of the leasing contract, according to the law," while also respecting the prevalence of the economical over the legal.

The same regulations establish the categories which apply the principle of prevalence of the economical over the legal:

- The legal persons who, at the time of the balance sheet, exceed two of the following size criteria: total assets of 3.650.000 EURO; net business of 7.300.000 EURO, and an average of 50 employees throughout the year.
- The entities which, at the time of the balance sheet, do not exceed two of the size criteria mentioned above, but which have consolidated financial situations; this category will apply the principle of prevalence of the economical over the legal only when preparing the consolidated financial situations.

In this form, the law is somewhat confusing, leading to the following question: do any other entities apply the principle of prevalence of the economical over the legal? If the answer is that they do not apply the "substance over form" principle, then how do they highlight in their records the leasing operations in general and the finance leasing operations in particular? Later, some qualifications [8] appeared, albeit tenuous, which define the leasing contract, finance and operating lease treatments, and the technique of recording in accounting the liquidation of the leased asset.

Regarding the application of the prevalence of economical substance over the legal form, there are no changes; there is only the mention that "the entities which apply the principle of prevalence of the economical over the legal will also take its requirements into account." By affirming this, the law renders the application of this principle legal by the authorized entities.

As a consequence, the entities which do not apply the principle will not be able to record the asset in their balance sheets, as a tangible asset, as the principle of patrimony would be a priority in this case. According to the patrimony principle, only the assets which are the property of the company are subject to the active balancing, and the passive balancing reflects the company's obligations to creditors and investors. If we are to apply the legal form and not take into account the economic substance of the transaction (the asset is a lessee controlled resource and provides future economical benefits for them), then the lessee will acknowledge in the financial situations the lease-related expenditures to the lessor. Applying this treatment, we will have financial situations which reflect a legal act and not an economical reality, the principle of patrimony being in conflict with the principle of prevalence of the economical over the legal. Moreover, the same nature of the transaction will be applied differently from one entity which applies the principle to another, relative to an entity which does not apply the principle.

One solution to solve this conflict between the two principles could be registering the right to use the asset as an intangible asset, also presenting, at equal value, the corresponding debt. This solution also has legal support, the rights of the subject being intangible capital.

In practical terms, the entities, regardless of their size, classify the leasing contracts according to the legal acts described above, and the accounting is done in accordance with the principle of prevalence of the economical over the legal.

Reference notes

- [1] Andreica, M. – Leasingul cale de finantare a investitiilor pentru pentru IMM, Ed. CRIMM, Bucuresti, 1997
- [2] OG no. 51/1997 was modified and completed by the Law 90/1998, Law 571/2003, and Law 28/2006.
- [3] OG no. 51/1997R with later modifications and additions
- [4] V. Raileanu and col. – Ghid pentru intelegerea si aplicarea Standardelor Internationale de Contabilitate, Leasing, Ed. CECCAR, Bucuresti, 2004
- [5] For other definitions see IAS 17, OMFP, 1752/2005 for the approval of accounting regulations which are consistent with European regulations and OG 51/1997 about leasing operations and associations
- [6] OMFP 1752/2005 for the approval of accounting regulations which conform to European regulations.
- [7] The expression “according to the law” contains some ambiguity for accountants. Unless otherwise stated, there will be the tendency for accountants to search for the most “comfortable solution,” but this is the fiscal form and not OG 51/1997 regarding leasing operations and associations, which is the special legal norm which regulates the leasing operations.
- [8] OMFP 2001/2006 for modifying and competing OMFP 1752/2005 for approval of accounting regulations consistent with European regulations
- [9] OMFP 1752/2005 for approval of accounting regulations consistent with European regulations

References

- 1. Andreica, M. – Leasingul cale de finantare a investitiilor pentru pentru IMM, Ed. CRIMM, Bucuresti, 1997
- 2. V. Raileanu and col. – Ghid pentru intelegerea si aplicarea Standardelor Internationale de Contabilitate, Leasing, Ed. CECCAR, Bucuresti, 2004
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