

Міністерство освіти і науки України

Національний університет харчових технологій

**80 МІЖНАРОДНА НАУКОВА
КОНФЕРЕНЦІЯ
МОЛОДИХ УЧЕНИХ,
АСПІРАНТІВ І СТУДЕНТІВ**

*“Наукові здобутки молоді –
вирішенню проблем харчування людства
у ХХІ столітті”*

Частина 4

10–11 квітня 2014 р.

Київ НУХТ 2014

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73. Accounting for leases

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Introduction: A lease is simply an agreement between two parties for the hire of an asset. The lessor is the legal owner of the asset who rents out the asset to the lessee. At the end of the lease the asset is returned to the lessor. The lessee will pay a lease rental to the lessor in return for the use of the asset. The accounting treatment for the lease entirely depends on the nature of the lease. For accounting purposes all leases are classified into one of two categories, they are either deemed to be 'finance leases' or 'operating leases'. At its most clear cut an operating lease is a very short-term agreement for the temporary hire of an asset, e.g., hiring a car for two weeks to take on holiday.

Resources and methods: There are two ways of accounting for leases. In an operating lease, the lessor (or owner) transfers only the right to use the property to the lessee. At the end of the lease period, the lessee returns the property to the lessor. Since the lessee does not assume the risk of ownership, the lease expense is treated as an operating expense in the income statement and the lease does not affect the balance sheet. In a capital lease, the lessee assumes some of the risks of ownership and enjoys some of the benefits. Consequently, the lease, when signed, is recognized both as an asset and as a liability (for the lease payments) on the balance sheet. The firm gets to claim depreciation each year on the asset and also deducts the interest expense component of the lease payment each year. In general, capital leases recognize expenses sooner than equivalent operating leases.

Results: The accounting treatment for an operating lease is straight forward for both the lessor and the lessee. The lessee has incurred an operating expense, so the lease rental payable is written off in the profit and loss account. The lessee has to disclose in the notes to the accounts the amount charged in the year and the amount of the payments to which the entity is committed at the year end. The lessor has earned revenue from renting out the asset and accordingly recognises the lease rental receivable as income in the profit and loss account.

A financial lease is a method used by a business for acquisition of equipment with payment structured over time. To give proper definition, it can be expressed as an agreement wherein the lessor receives lease payments for the covering of ownership costs. Moreover, the lessor holds the responsibility of maintenance, taxes, and insurance.

A financial lease is similar to an out-and-out purchase transaction which has been financed through a term loan, in that the payments are made on a monthly basis. However, unlike an out-and-out purchase transaction in that the lessee doesn't present the obligated balance as debt, shows payments as expensed, and retains the equipment title. During the lease period, the finance company is considered as the legal owner of the asset. A finance lease is one where the risks and rewards of the ownership pass to the lessee. How it is determined that risks and rewards have passed is a subjective issue and one on which accounting standards give guidance (see below). At its most clear cut, however, a finance lease is a long-

term agreement representing a loan made by the lessor to the lessee to buy the asset. The principle audit risk, associated with leases concerns their classification. If what are in substance loans to buy fixed assets are accounted for as operating leases, then the financial statements will not show a true and fair view, as there will be off balance sheet assets and liabilities. This risk is higher if the company's gearing may be considered too high.

However, to account for the finance lease in accordance with its legal form would be a betrayal of the concept of 'substance over form'. This important concept requires that the commercial reality of events and transactions be reported in the financial statement if they are to be relevant to the users of the financial statements and if the financial statements are to be true and fair.

The lessee strictly capitalises the present value of the minimum lease payments as the fixed asset and this is the amount also recorded as the liability. The present value of the minimum lease payments normally equates to the cash price. The asset has to be depreciated over the shorter of the period of the lease and the useful life of the asset. The loan accrues interest which should be recognized to give a constant periodic return on the balance of the outstanding loan. The rental payment is not therefore simply a revenue expense but represents partly the repayment of the capital element of the loan and partly the finance charge on the loan (i.e., interest).

Conclusions: On the balance sheet the finance lease creditor obligation under finance leases will have to be split between current and long-term creditors. In the notes to the balance sheet a separate listing in the fixed asset schedule is required to distinguish assets legally owned and those held subject to finance leases. In the notes to the profit and loss account the amount of the interest charged that was in respect of finance leases must be disclosed. The principle audit risk, associated with leases concerns their classification. If what are in substance loans to buy fixed assets are accounted for as operating leases, then the financial statements will not show a true and fair view, as there will be off balance sheet assets and liabilities. This risk is higher if the company's gearing may be considered too high.

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