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PROBLEMS AND SOLUTIONS FOR LEASE VALUATION AND ACCOUNTING IN LATVIA

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Abstract. In the legislation of the Republic of Latvia, leasing transaction accounting complies with the provisions no. 17 of the International Accounting Standard "Leasing", which expired on January 1, 2019. The problem for the lessee in the accounting of leasing transactions is also the introduction of a new standard for companies that prepare annual financial reports in accordance with the requirements of international accounting standards. The aim of the study is to examine accounting problems and assess leasing transactions in Latvia and offer solutions. The study examined the justification for the assessment and accounting of leasing transactions in line with international accounting standards and identified issues of assessment and reporting in Latvia, possible solutions to improve the quality of leasing transactions have been worked out, offering necessary changes in legislation and revision of methodological documents.
Keywords: financial leasing, operational leasing, lessee, lessor, leasing liabilities.

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Introduction

In the Republic of Latvia, lease transactions are quite widespread, since not every company can immediately acquire land, buildings, production equipment, or vehicles, so the lease is used. It is important that the users of the financial statements could see the existence of the lease agreement in a clear and understandable way in the financial statements of the companies. The former International Accounting Standards No.17 "Leases" (IAS 17) were criticized for not always allowing the users to fully recognise and see the complete picture of the corporate assets and liabilities. In turn, accounting problems may arise with the adoption of the new International Financial Reporting Standards No.16 "Leases" (IFRS 16) on January 1, 2019, which changes the lease definition and its presentation in the lessee's accounting. Depending on the preferential approach, the lease can be recognized on the date of adoption of the standard, assuming that the lease takes effect on that date. However, it should be taken into account that the standard also stipulates how to handle the leases concluded before 2019. IFRS 16 does not require the lessor to make adjustments, but may result in the necessary adjustments for the intermediate lessor transferring asset to a sublease.

It should be noted that the legislation of the Republic of Latvia complies with the old lease standard, which may cause problems in the accounting of lease transactions.

Research aim: to investigate problems of accounting and valuation of lease transactions in Latvia and offer solutions.

The research methods: the monographic or descriptive method, document analysis, the logical and constructive methods, and the graphic method.

Legislation of the Republic of Latvia, international accounting standards, and the scientific research of the other authors were used as the basis of the research.

In the study, the authors have investigated the rationale for the valuation and accounting of the lease transactions in accordance with the international accounting standards and have identified problematic issues regarding their valuation and reporting in Latvia. In a result, the authors have developed possible solutions for improving the quality of accounting for the lease transactions by proposing necessary amendments to the legislation and revision of the methodological documents.

Interpretation of the concept of lease

For decades, discussions on the development of a common approach to the lease transactions have been ongoing. R. Hussey and C. F. Fajardo in their studies review the discussion of the US Financial Accounting Standards Board and the International Financial Reporting Standards Board on developing a common approach to the lease accounting and other standards *(Fajardo, 2016)*. Lease accounting should ensure that all the assets and liabilities arising from the leases are recognized in the statement of financial position. The results show that the biggest disagreement has referred to the fact that the lease was recognized as an asset in the financial statements *(Hussey, 2018)*.

When examining the definition of lease, the authors have identified that the lease is based on a contract and a payment for the asset received. Transfer of the tangible assets (land, etc.) based on a contract for use by the lessee for which the lessee pays the rent *(Ekonomikas skaidrojošā vārdnīca, 2000)*. The lease is a contract stipulating that the lessor transfers to the lessee the right to use the asset for a certain period in exchange for the lease payment. A financial lease is a lease, which, in fact, transfers all the risks and rewards that define ownership of an asset. Property rights may be or may not be transferred. Operating lease is a lease, which is not finance lease *(EU, 2008)*. Under IFRS 16, a lease is defined as a contract or part of a contract that grants the right to use the asset for a specified period in exchange for payment *(EU, 2017)*. It follows from the definition that when a company signs a contract, it is necessary to consider whether the contract is a lease or includes a lease. The new definition of lease is focused on whether the right to control the use of the asset during the lease is acquired in exchange for payment. This is an issue requesting a judgment, and the rules for implementation of IFRS 16 provide guidance for the considerations (See Figure 1).

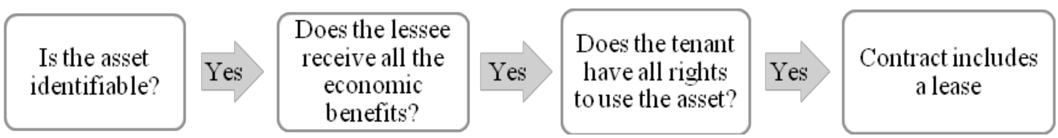

Fig. 1. Considerations for determining whether a contract includes a lease *(EU, 2017)*

Regarding the asset identification, it should be considered whether the asset is clearly identified in the contract and whether it is indistinguishable at the time when it is available to the lessee for use. The economic benefits of using the asset include the basic benefits (output, capacity) and the incidental benefits deriving from the asset, as well as the other economic benefits that could arise from a commercial agreement with a third party (for example, a sublease). In order to determine whether the lessee has all the rights to use the asset, it is necessary to evaluate who, in fact, during the all period of lease makes the decisions on what purpose the asset is used. If all the decisions on the use of the asset are stipulated in the contract, then it can be considered that the lease exists.

In Latvia, both rent, lease, and leasing are actually considered as a lease. For example, office or retail space rental, car operating lease, financial lease of production equipment.

The benefits provided by IFRS 16 allow the lessee not to consider as a lease the lease of an asset, which is short-term (up to 12 months) or is of low value, such as mobile phones, computers, and other office equipment. Note that the lease term is determined on the date when the lessor provides the lessee with the availability of the asset, and a lease cannot be considered the short-term lease if the contract includes option of a redemption. IFRS 16 does not specify the amount to be considered as a low value, though the accompanying Annex "Basis for conclusions" refers to the estimates of the IFRS Council mentioning the sum of 5,000 USD. It should be noted that the value of the asset should be considered when it is new, and this exemption does not apply to the assets that are to be subleased *(Lipsane, 2018a)*. The authors believe that companies in their internal regulations should determine what to consider as low value leases.

In Latvian legislation, accounting for leases is similar to IAS 17, which determined the classification of leases in finance leases and operating leases. IFRS 16 no longer provides such a lease classification for the lessees who are required to present in the balance sheet the assets and liabilities for any type of lease. In Latvia, the "Law on the Annual Financial Statements and the Consolidated Financial Statement" provides that, for justified reasons, the company can recognize, evaluate, and present the balance sheet items of assets or liabilities in the financial statements and provide explanatory information on these items in accordance with the International Financial Reporting Standards (Law on the Annual Financial Statements and Consolidated Financial Statements, 2015). The authors note that such a choice is important for the company's subsidiaries if the company prepares an annual report in accordance with International Financial Reporting Standards. The authors propose to the responsible structural units of the Ministry of Finance of the Republic of Latvia to develop methodological guidelines for the accounting and valuation "Lease", where the current principles of accounting and valuation of lease transactions are explained in detail in accordance with the requirements of IFRS 16.

Lease transactions in the lessee's accounts

With adoption of IFRS 16, the lessee's access to accounting of all types of leases is equalized. If a finance lease was previously recognised in the company's balance sheet, then, after the adoption of IFRS 16, the names of the balance sheet items are simply changed, while the operating lease that was not previously presented in the balance sheet now is included in it. It will have several consequences in the lessee's financial statement (See Table 1).

Table 1

Presentation of the lessee's accounting in the financial statements *(EU, 2017)*

Balance sheet	Profit and Loss Statement (P&L)	Cash flow
- Lease commitments – presented separately or included in other liabilities by disclosing information in the notes on the accounts. - Right-of-use asset – presented in a separate balance sheet item or combined with existing assets, disclosing information in the notes to the accounts.	- Interest expense on lease liabilities. - Depreciation/ impairment. - Variable lease payments.	- Total cash flow associated with lease payments. - Interest payments. - Short-term, low-value and variable lease payments in the course of economic activities.

It has to be noted, that lease payments are not anymore included in P&L. Right-of-use asset is a long-term item of a balance sheet, comparable to an intangible asset, an asset or an investment property.

The amounts recognized in the financial statements are determined at the commencement date of the lease. The following three aspects should be considered carrying out the initial valuation of the lease:

- lease term;
- lease payments;
- discount rate.

The periods to be included in the lease term are:

- irrevocable lease agreement – a period covered by the contract rights and obligations;
- periods with a possibility of renewal/extension of the contract;
- periods after the date on which there is an option to terminate the lease.

The lease liability is calculated as the present value of all expected lease payments made up of:

- fixed rents paid during the lease period;
- variable rental rates linked to a rate or index;
- price of redemption in the event this option is provided in the contract;
- fines if they are foreseeable and it is reasonable to believe that the contract will be terminated prematurely;
- any other residual value guarantees provided by the lessee to the lessor.

Changes in IFRS 16 concern the guarantees for the residual value, because IAS 17 required the lessee to include the maximum guaranteed amount in the lease payments, while IFRS 16 requires the lessee to estimate and reassess the guaranteed residual value but does not provide guidance on how the estimate should be made.

Variable lease payments are not included in the lease liability calculation but are included in P&L in the period they relate to. An example of a variable lease payment is the rent depending on the turnover of the retail outlet.

The lease liability is recognized at the discounted value of all expected lease payments. If the lease agreement does not include a discount rate, the basic borrowing rate at the commencement date of the lease is applied. Although the use of the discount rate included in the lease is preferable, the lessee may find it difficult to determine the rate that the lessor has applied to it. For example, the lessee will often not know the original direct costs of the lessor or will only have limited information about the expected residual value of the leased asset at the end of the lease period. Hence, the lessees will often use their available borrowing rates at which the lessee could borrow an amount for a similar period at the date of commencement of the lease to acquire the asset with a value similar to the lease asset in the same currency, with a similar collateral, in similar economic circumstances. I. Lipsane points out that the discount rate used by the lessee and the lessor will often be different for the same lease agreement *(Lipsane, 2018b)*.

Right-of-use asset at the time of its initial recognition includes in the costs the following:

- the initial valuation of the lease liability;
- prepayment for the lease, less any rental incentives received from the lessor;
- initial direct costs related to the conclusion of a lease agreement (for example, a rental contract or a resignation fee to the existing lessee);
- restoration costs (for example, the cost of repairs of the future premises before relocation if the contract provides for such costs). A provision is made for the cost of restoration in the balance sheet liabilities.

After the lease is recognized at the moment of commencement, the subsequent accounting for the lease begins. Interest on the lease is recognized as an interest expense at the effective interest rate. Lease payments reduce the lease liability and no longer appear directly in P&L. The right-of-use asset depreciates and is subject to valuation impairment. If the company applies the revaluation method to fixed assets and intangible assets, it should also be applied to a similar category of right-of-use asset.

Lease transactions in the lessor's accounts

The adoption of IFRS 16 does not introduce significant changes in the lessor's accounts. The standard retains all the existing criteria for determining the finance lease, while the rest of the lease is classified as an operating lease. The new IFRS 16 just reinforces disclosure requirements for the lessors with respect to the exposure to risk, in particular the residual value risk.

L. Alver points out that if a sale and leaseback results in a finance lease, any excess of sales proceeds over the carrying amount should be recognized as a loan, and sales revenue is not recognized *(Alver, 2005)*. IFRS 16 excludes the possibility of maintaining off-balance-sheet financing schemes under "sale and leaseback" agreements. If IAS 17 had focused more on the "leaseback" side, then IFRS 16 focuses on the sale side: is the sale really a sale under IFRS 15 "Revenue", i.e. is the control of the asset transferred from the seller who will take on lease the asset to the buyer who will grant on lease the asset. If this is the case, the transaction is recognized in the balance sheet at cost, subject to the general requirements of IFRS 16. If control is not transferred, the sale and leaseback cannot be recognized and the "lessee" recognizes the transaction as a financing *(Lipsane, 2018c)*.

T. Labzova points out that attention should be paid to the lessors who do not own the leased asset themselves and who derive income from the sublease. If previously the sublease was in the most cases attributable to the operating lease, then with adoption of IFRS 16, a large part of the lease transactions should be included in the balance sheet of the intermediate lessor *(Labzova, 2019)*. IFRS 16 provides that a sub-lease shall be valuated applying the right-of-use asset, i.e., applying the same criteria to the sub-leased part as would be applied to evaluating whether an asset owned by the company was transferred to finance or operating lease. As a result, many subleases that were classified as operating leases before may become financial leases. R. C. Graham and K. C. Lin states that capital lease assets and operating lease assets have fundamentally different characteristics *(Graham et al., 2018)*. The authors conclude that the lessor has to evaluate the lease transactions more strictly, when there is a sublease, in order to indicate if it can be equated with the sale.

Problems of lease accounting and valuation in Latvia

The transition to the application of the new IFRS 16 affects mostly those Latvian companies whose lease agreements were classified as operating leases under IAS 17. First, it is necessary to identify the contracts that are covered by the definition of lease and the contracts that are not covered by the exemptions. In the transition to IFRS 16, the company has to decide on the choice of the transition method that may affect the balance sheet and P&L result (See Table 2).

Table 2

Methods of applying IFRS 16

Retrospective application	Modified retrospective application
- Displays comparative information for all indicators. - Cumulative effect is recognised on the previous comparative period. - Limited reliefs for a simplified transition.	- No need to present the changed comparative information (presented in the notes to the financial statements). - Cumulative effect is recognized as the adjustment of the opening balance of retained earnings. - Several options for a simplified transition.

Sourse: *(EU, 2017)*

Comparing the two transition approaches described above, Lipsane points out that the modified retrospective method is simpler because the lessee does not have to look for historical information to determine the amount of the liabilities. By applying the retrospective method, no further relief is provided; still, it improves the comparability of data *(Lipsane, 2019)*. The authors would recommend the Latvian companies to consider using the modified retrospective method, especially those who can benefit from the reliefs.

The discussions encouraged by scientists regarding the IFRS 16 implies that from the beginning of 2019 almost all leases will be treated as finance leases. This means that underlying assets (and corresponding liabilities) will be recognized on balance sheet, which may change financial situation (assessed on the basis of financial ratios) of many companies *(Czajor et al., 2017)*. The authors have discovered that changes in the lease accounting have an impact on financial ratios of the balance sheet. This means that the financial analysis data of the companies will change with the adoption of the requirements of the new standards. The companies whose financial performance is being assessed should note this. Operating lease capitalization increases profitability measured by earnings before interest and taxes, earnings before interest, taxes, depreciation, and amortization or net income *(Lee et al., 2014)*. Increases in leverage ratios and decreases in case of debt ratios, liquidity ratios and in return on assets *(Fit et al., 2013)*. M. Bauman and R. Francis investigate the impact of lease accounting on the quality of financial statements and how it affects the changes in the balance sheet value *(Bauman et al., 2011)*.

Evaluating the implementation of IFRS 16 in Latvia, T. Labzova points out that this will have a significant impact on the company's balance sheet as not only the long-term assets will increase, but also long-term and short-term liabilities. Available estimates suggest that it will not have a significant impact on the net profit figures, as the lease expenses will be replaced by the depreciation and interest expense. However, IFRS 16 will have a significant impact on the P&L structure improving earnings before the interest tax depreciation and amortization and increasing the interest expense position *(Labzova, 2019)*.

The authors note that significant lease transactions will affect the companies that lease most of their assets. As a result, an increase in liabilities may affect the capital structure ratios, which in turn may have a negative impact on the ability to borrow.

By the adoption of IFRS 16, there is no symmetry in the accounting of the lessees and lessors. Although the lessee presents a liability to pay the lease, the lessor continues to present the fixed assets in its balance sheet and does not present the financial assets for its right to receive leasing payments *(Lipsane, 2018c)*. The authors also draw attention to the fact that differences in the accounting of the lessee and the lessor will result in the application of different discount rates.

Conclusions and suggestions

In the legislation of the Republic of Latvia, the accounting for lease contracts is governed by the Law on the Annual Financial Statements, which includes the definition of lease provided by IAS 17. The authors propose to the responsible structural units of the Ministry of Finance of the Republic of Latvia to develop methodological guidelines for the accounting and valuation "Lease", where the current principles of accounting and valuation of lease transactions are explained in detail in accordance with the requirements of IFRS 16.

The lessee no longer presents the rental costs in P&L. Right-of-use asset is a long-term balance sheet item that is equal to an intangible asset, fixed asset, or an investment property for which depreciation is calculated. For the lessors, IFRS 16 excludes the possibility of maintaining off-balance-sheet financing schemes under "sale and leaseback" contracts, and stipulates that sub-leases are subject to the same criteria as when assessing whether an asset held by an entity has been grant on finance or operating leases that may change a type of the lease.

Transition to the application of the new IFRS 16 affects mostly those Latvian companies whose lease agreements were classified as operating leases under IAS 17. The authors suggest that Latvian companies shall consider using a modified retrospective method from the two methods offered, as they can benefit from the reliefs, and it is simpler.

The adoption of IFRS 16 in Latvia increases long-term assets and long-term/ short-term liabilities in the company's balance sheet. As a result, an increase in liabilities may affect the capital structure ratios, which in turn may have a negative impact on the ability to borrow. After the adoption of IFRS 16, there is no harmonization of the accounting for the lessees and lessors regarding mostly the operating leases, as well as the application of different discount rates.

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