Global Journal of Management and Business Research: C Finance
Volume 23 Issue 1 Version 1.0 Year 2023
Type: Double Blind Peer Reviewed International Research Journal
Publisher: Global Journals
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

The Practice of Reflecting Leasing Transactions in Financial Statements

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Summary- The subject of the article is the analysis of the practice of reflecting leasing operations in financial statements. The object of the study is the existing system in Azerbaijan of accounting for financial lease agreements between the parties to the lease agreement on accounting accounts. At the same time, serious attention is paid to the activities of Azerbaijani leasing organizations engaged in financial leasing. The theoretical and practical basis of the study was the fundamental concepts and approaches presented in the works of both domestic and foreign authors, scientists in the field of legal and accounting regulation of transactions under lease agreements, legislative and regulatory acts of the Republic of Azerbaijan. Statistical and analytical materials, periodicals, monographs, dissertations, Internet publications of official sites were used as a research database. The practical significance of the study lies in the development of practical provisions and recommendations for accounting and reporting by the lessee of operations under financial lease agreements, aimed at solving the problems of ensuring the reliability of financial statements and adapting them to international accounting standards.

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GJMBR-C Classification: JEL Code: F65

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I. Introduction

In last few decades we witnessed major changes in the international capital markets, the financial products that major financial institutions and banks provided, have been multiplied in order to attract investors and satisfy the loanees. The major financial institutions have expanded their activities offering new services and products. This was the main reason that the worldwide economic crisis begun. Leasing was one of those new products that banks offered in order to help businesses to renew or buy equipment such as real estate, machinery, professional vehicles etc. Leasing was a product that market needed in order to solve a major problem, this problem was that the business, without the use of leasing should cover a major part of the total cost of the investment. Many banks have successfully responded to the new conditions of the market and started lending in order to expand their activities. Consequently banking sector has a major contribution to a country's development. Via banking institutions businesses cover a wide range of their needs. Financing programs that are issued by banks are used to cover the needs of various enterprises in order to proceed with their investment activity or even support their productive activities. Banks adjust their long term lending according to the need of the companies that invest in the acquirement or the renewal of their fixed equipment. Concerning the needs that arise from the standard production activity, banks also provide the appropriate funding adjusted to each company. The question that arises at this point is how can a business decide which type of financing is suitable for its needs?[1] Leasing or loan?[2] And if the choice is lease, what type of lease would serves the best in the interest of the business? Through accounting examples there will be a comparison between leasing and loan in the financial statements of companies. The past few years, banking system has suffered the consequences that have derived from the economic crisis that occurs in the country. The alternative ways of funding that are considered to be more efficient than the traditional methods and are provided by banking sector in Greece, have also been affected.

In this uncertain environment, is there any way for banks to predict their needs in the leasing market in order for them to be better prepared?

The most widespread of the alternative methods of financing provided by banks is leasing, the concept of which will be analyzed throughout this dissertation as well as the utility that it provides to a company as alternative way of financing. We will also attempt to predict the future penetration of leasing in the various fields of use, using linear regressions, something that could be of great interest for banks' executives and administration in order to redesign the structure of institution and individual departments in order to be

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[1] An Yan (2006), Leasing and Debt Financing: Substitutes or Complements? Journal of Financial an Quantitative Analysis, vol. 41, No 3, September 2006

[2] John R. Ezzell, Premal P. Vora (2001), Leasing versus purchasing: direct evidence on a corporations motivations for leasing and consequences of leasing, The Quarterly Review of Economics and Finance, Volume 41, issue 1, pg. 33-47

consistent with the commands of the economic conditions.

a) Introduction in Leasing

The only common definition existing for lease, on a European level, is the one provided by the international accounting standard for leases IAS 17, where lease is defined as "an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time" [3] . Leasing is an international term that is used to describe the transfer of the right to use a fixed asset from the lessor to the lessee for a certain payment for a specific number of years in the form of lease. Lessor is the owner of an asset that is leased under an agreement, while the lessee is the person who rents the asset from the lessor and is legally bounded towards the lessor to uphold specific obligations that are defined in the leasing agreement and by the law. In general, leasing is a form of medium to long term funding of businesses and professionals in order for them to acquire fixed assets such as building and machinery that are of great significance to the continuing of their professional activities. The institution of leasing has been introduced in the Greek market in two stages. During the first stage, through the law 1665/86 was introduced the portable property leasing, which covers the need to lease any mobile asset that can be used for professional usage. During the second stage through the laws 2367/95 and 2682/99 the institution of leasing was expanded to the lease of real estate that is also used for professional usage.

b) Types of Leasing

The IAS 17 effectively accounts for the economic substance of the two major types of leasing that are:

Economics lease that transfers substantially all the risks and rewards incidental to ownership of an asset with title that may or may not be transferred eventually. Operationallease that is a lease other than finance lease. The first indication that proves weather a lease is finance or operating is to assess the risk and rewards of ownership have been transferred to the lessee.

c) Commercial Leasing

In a commercial lease, the lessor capitalizes the total amount of quality or attributes and then the lessee, who needs the equipment or machinery, uses it in exchange for fixed payments. This particular type of lease is also known as a full-payment agreement, in which there is a complete transfer of all risks and benefits associated with the asset from the lessor to the lessee. Ownership of the asset passes to the lessee at the end of its life. Typically, the term of the contract extends over most of the economic life of the asset. In this type of lease, the lessor plays the role of financier only. Large business equipment is a public example of a finance lease. When the contract period ends, it is often possible to continue the lease at a reduced rate or even to purchase the leased asset at a reduced price. Under IAS 17, a lease can be considered commercial if one or more of the following conditions exist.

- Ownership passes to the lessee at the end of the lease term, as it does in lease-purchase transactions.
- The lessee has an option to purchase the asset at a bargain price, such that the option is almost certain to be exercised.
- The lease term, which may even include a secondary term, is for most of the life of the asset.
- As of the lease commencement date, the present value of the minimum lease payments (MLP), including any down payment, is at least substantially all of the fair value of the asset (at least 90%).
- The leased asset is specific in nature, such that only a resident can use it without the need for significant modifications.
- The lessee pays compensation to the lessor if the lease is terminated.
- Gains or losses from fluctuations in the fair value of the asset are borne by the lessee.
- The lease is not subject to cancellation or is cancelled only with a penalty to the lessee.
- The lessee has the option to keep the lease for a secondary period at a rent that is substantially less than the market rent, such as a nominal rent.

If at any time the terms of the lease change, resulting in a different classification at the start of the lease, the lease is cancelled and the revised lease is treated as a new lease.

d) Operational Leasing

In an operational lease, the term is much shorter than the full economic life of the asset. The lessee does not bear the full burden of all the risks associated with the investment and is not responsible for financing its full value, but neither does the lessee acquire all the benefits derived from the asset. The leaseholder bears ownership along with all of the risks and benefits and depends on many different lessees to recoup the value of the investment. In this type of lease, the lessor provides not only financing, but also any other additional services that will be necessitated by the use of the asset. This form of lease is commonly used by companies that need to update or replace equipment frequently, such as music systems, vehicle fleets, and aircraft fleets. Assets in operating leases usually have a resale value.

[3] ACCA (2012), "Financial Reporting (FR)", Kaplan publishing, pg. 276

When the lessor enters into an operating lease, the lessor continues to recognize the leased asset. The leased asset is recorded on the statement of commercial position and depreciated in the normal manner. Lease income is recognized in the income statement on a straight-line basis over the lease term. If a difference arises between the amounts accrued and paid, it is adjusted as a receivable or deferred income. If the lessor is a manufacturer or dealer, a gain on sale should not be recognized at the inception of an operating lease because the risks and rewards are not transferred to the lessee, it is not treated as a sale.

A reverse lease is a form of lease agreement in which the owner of an asset sells it to another party, usually a financial institution or leasing company, and then immediately enters into a lease of the asset with the buyer for a specified term. The seller, while losing ownership of the asset, retains the right to use it for the agreed-upon term of the lease. On the other hand, the buyer has a guaranteed immediate and long-term income on the asset from the lease payments. This type of lease is usually used when the entrepreneur wants to purchase capital that has been tied up in long-term equipment. Reverse leasing is used as an alternative to loans when the value of the payments is lower than the cost of the loan or even when the company wants to show less debt on its balance sheet (off-balance sheet financing). Reverse leasing transactions are often used for commercial vehicles, commercial real estate and other types of property.

Vendor leasing, also known as asset leasing, is a type of lease based on the creation of an economic agreement between retailers who supply stationary and mobile equipment and their business customers. It requires the retailer to make a deal with a funding source, such as a leasing company, so that the seller can offer leases to customers. By offering financing, the seller makes a cash sale while obtaining financing from a commercial institution. Through leasing, the vendor fully or partially replaces the leasing company because the vendor can be responsible for signing contracts and collecting rents. Depending on the deal, the supplier may also collect the lease payments and pass them on to the financing institution, or the customer may pay the financing company directly. The financing company usually handles the customer's credit check and operational administration. The seller then presents the financing option to the customer, and if the customer accepts it, the seller receives the money from the financing company. Through the vendor, leasing companies are able to fulfill their orders and get the financing they need to do so without having to apply for a bank loan first. There is a huge variety of equipment that can be used through vendor leasing, such as trucks and cars, computers, forklifts, medical printers, and there is the option of signing or repurchasing under warranty from the vendor. Vendor leasing helps drive vendor sales and creates a stronger vendor-customer relationship. Lessee and lessor accounting depends on the classification of the lease, whether it is a finance lease or an operating lease.

In this type of lease, the lessor borrows the amount of financing needed to purchase the asset. Unlike other types of leases where there are two parties involved (lessor and lessee), a leveraged lease has another party. The third party plays the role of a lender who helps with the financing needed to purchase the asset to be leased. The lessor plays the same role as in the previous types of leases. The loan is secured by a mortgage on the asset as well as the legal transfer of the lease and payments. In addition, the lessor can guarantee repayment of the debt. In some lease terms, the lessee issues bills of exchange that are guaranteed from the lessor. This guaranty reduces the risk in which the byers of the bills of exchange (borrowers) are exposed reducing therefore the cost of borrowing.

e) Purpose of Leasing

Leasing constitutes an alternative and flexible way of financing businesses activity compared to the traditional ways of medium-long term bank loans. Therefore, leasing constitutes a mechanism that provides the business the chance to acquire, complete, renew or expand its productive equipment avoiding the usage of the company's capital. Leasing as a form of finance has advantages for the lessor, the lessee and for the national economy as well. The lessee is being financed with the total amount of the investment from the leasing company without the need of disbursement and the participation of the lessor. The procedures are quick and simple while the tax and other motives that the investor has been able to achieve through the various development laws are not jeopardized. Leasing does not require additional safeguards such as mortgages or permutations. As the time schedule of payments is concerned, it is appeared to be very flexible, something that is very important especially for the businesses, which present seasonality in cash, flows. A very important aspect for the company is the tax deduction of the total amount of the lease that is combined to the shorter duration of the contract from the useful life of the equipment. Moreover, the business is protected from the technological depreciation of the equipment while the liquidity of the lessee is increased with the use of sale and leaseback possibility. Through leasing procedure the lessee is able to obtain capital equipment without charging the credit limit that is preserved in the banks and without the use of own equity. In addition, the lessee is given the possibility of preserving his liquidity, as he does not have to use his own capital in order to acquire the asset.

According to international experience, the cost of leasing is usually slightly higher than the cost of the equivalent banking lending. Therefore, the choice between leasing or using bank loan should be based in analyzing each case separately, as data (cost of capital, depreciation e. c. t) differ in each case. The interest rate used differs between leasing companies and between times periods. Additionally, interest rate changes according to the conditions that exist in the market consequently having an effect on the lease payments. Therefore, the lease payment is not stable or independent from the changes in bank interest rates. As the commercial institution (lessor) is concerned, has to face less danger than the issue of a loan, given the fact that the lessor preserves the ownership of the fixed asset as opposed to the lessee, who in case of danger has to deal with the cost and delay in order to acquire the possession of the assets that has financed. Therefore, leasing company obtains insurance of tangible nature due to the right of high ownership, which provides a high mean of protection and in the same time a significant advantage over the rest of the collateral types. Leasing as a new mean of finance has expanded the banking clientele and is offering new chances of business activities.

f) Leasing Development and Influence in the Economy of Azerbaijan

In the Azerbaijan market, the asset finance and equipment leasing are controlled by the banking sector, since banks are in charge of leasing companies and there are no captive lessors. Every bank that has a leasing department is a member of the Association of Azerbaijan Leasing Companies (AGLC), which in turn is a member of Leaseurope. Over the past few years, Azerbaijan's economy has been severely damaged by the global economic crisis, a leading banking system under pressure and major restructuring that will inevitably lead to fewer leasing companies. Until 2002, leasing was mainly used to finance movables all types of equipment except naval vessels but including aircraft. In 2002, the legislation was changed to include real estate, from then until 2007, Azerbaijan's leasing market experienced steady growth, but that was when the first signs appeared, an impending crisis appeared.

During 2007 and 2011, new business declined each year, but during 2009-2010, leasing companies were still supported by their parent banks. Commercial leasing in Azerbaijan was not seriously affected in 2008, when the economic crisis in the United States and Europe was evident, and it worsened in 2009 and 2010 appeared, but in 2011 there was a serious decrease in the commercial leasing market. The ongoing uncertainty and instability in the Azerbaijani economy has a negative impact on the investment initiatives of both lessors and lessees. These conditions are best expected to change after the recapitalization of the banks, which will provide liquidity in their leasing subsidiaries and in turn drain it. to the market that helps the economy progress.

In Azerbaijan leasing is particularly preferred in financing oil, liquid gas and real estate, since it presents the highest amounts since 2005 that are followed by a very steep decrease from 2007 until 2011. Machinery, having much less volume than oil, liquid gas and real estate, comes in second place, also having decreasing trend from 2006 until 2011, with a small increase in 2008. The percentages of equipment and other types of leasing are not very widespread in Azerbaijan, since they are presenting the lowest figures since 2005 with a small increase in 2008 that is followed by a decrease until 2011.

II. Methodology

As contemplating on other papers mentioned above, we believe that there is a linear relation between some factors such as profitability, growth rate, profit volatility etc., and the total leasing activity. Our inspiration is that, although Greek economy is struggling in an unstable and uncertain economic environment, we will be able to provide banking sector with a tool that predicts the future needs for leasing in the different fields of use, in order for them to be prepared for the market needs. Linear models are based on the relation $y=ax+b$, where y is the predicted values and x are the independent variables, b is the steady term which shows the starting point of the graphical presentation and is directly connected to the magnitude of each model.

III. Conclusions

In Azerbaijan, the entrance of leasing activity took place later on than the rest of the European community, but the growth rates for the years 2001 to 2008 were even higher than the rates in Germany and Great Britain. This can be explained by the huge expand of lease in the oil, liquid gas and real estate sector and the reliefs in transfer taxes that were provided. Azerbaijan has been suffering for almost three years now, from an economic crisis that affects every prospect of economic activity. As a result, leasing activity has also been affected. We believe that the decrease of the leasing percentages in the market reflects equally the total shrunk of Azerbaijan economy. In the third chapter of our thesis, we try to provide the information necessary for an entrepreneur in order for him to decide if leasing is the appropriate way of financing of his business. In the fourth chapter of our thesis, we examine with the data available from Bank of Azerbaijan and from Association of Azerbaijan Leasing Companies, and with the tools of linear regression, to see if there is any connection between the total economic activity of the country for each year and the amount of money concerning leasing sector in the country. Linear regression is a simple model to predict future behavior of the market. The preciseness and value of the model itself has a direct connection with the number of independent variables of the model and the quality characteristics of them. Our single independent variable, which was the previous years, represents the total economic activity in leasing sector and we demonstrate that there is good fit using the data for the years 2007 to 2011, having linear relation with a decreasing trend. The results we present are decreased as expected and comply with the total economic conditions in Azerbaijan. There are also other tools in order to examine and work with the available data, such as Markov chains. Another very useful tool commonly used in this area from leasing companies in order to estimate the risk of loses for an investment using leasing is the simplex method with tables. These two methods need data with various quality data. Adding more variables in the model and refining it for further accuracy could be a future work.

We could say that results that derive from regressions as the one we have used can help banks and commercial institutions to better reorganize and structure their leasing departments in order to keep up with the demands of the market. We strongly believe that for the year 2012 the leasing market will continue to shrink down to minimum level, as companies will have neither the sufficient funds to continue the leasing nor the need to expand their activities. This will affect the market with a decrease of the prices in equipment (including real estate) which will trigger actions from investors to lease again equipment in new lower prices. Consequently, this state of the market will set the minimum level of leasing activity for every sector. In some cases, as we saw in machinery leasing, this can be predicted. Finally, we believe that these conditions could be reversed by giving motivation in entrepreneurs of other sectors of the Azerbaijan economy third party financing, technology performance financing and energy service companies, the last is expected to have great growth in the next few years.

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