

CANCELLATION OF A LEASING CONTRACT – EVALUATING THE ASSET REGAINED

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The most recent financial crisis had many effects during the last year. Majority of the existing companies, worldwide, were harmfully influenced by it. More important, professions and economies were shocked by the crisis. Romania is no exception from the rule. Our article focuses on Romanian financial leasing companies, in a pretty difficult period, and its subject is how lessors are supposed to evaluate and recognize the asset regained when the financial leasing contract is cancel due to lessee's inability to pay its monthly invoices.

Keywords: Financial crisis, financial leasing, evaluate, fair value, cancellation of a leasing contract

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1. Introduction

In Romania in the last quarter of 2008, the leasing market decreased by almost three times as compared to the second or third trimester of 2008⁵¹².

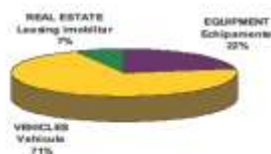


And this reverse trend comes after 4-5 years of increasing annually by almost 50% (medium yearly increase). But in 2009 numbers may look even worse than in assumptions. This is because the Romanian leasing market is structured as follows: 71% vehicles, 7% real estate and 22% equipments⁵¹³.

⁵¹² "Romanian leasing market for 2008", ALB Romania, www.alb-leasing.ro;

⁵¹³ "Romanian leasing market for 2008", ALB Romania, www.alb-leasing.ro;

2008 Romanian Leasing Market Structure by Asset Type
Structura pietei de leasing din Romania dupa tipul bunului
4,817,654 (000 euro)



Strada/Straz: ASOCIATIA SOCIETATILOR FINANCIARE - ASB ROMANIA

Due to financial crisis, many common people that could have easily accessed a finance leasing in 2006-2008 have nowadays problems with paying monthly payments for their cars (considered luxury good more than necessity goods). During the crisis the demand of luxury goods is the first that decreases. Also important, depreciation of Romanian currency led to higher monthly payment for leasing contract.

Under these conditions, most of the Romanian financial leasing companies are in the position to cancel their contracts (usually after three unpaid invoices) and to recover the goods. Nowadays, the number of recovered good is increased by 4-5 times then the last years. The situation is not easy for Romanian leasing companies due to the tendency of the cars' value to depreciate significantly (especially for second hand cars), to the decreased demand on the market for cars, to the higher cost with storage and current repairing of such used cars and due to the difficulty to measure the value of the goods returned and the value of the loss.

For the rest of the article we will stay focus on measuring the values of returned goods from canceled financial leasing.

2. Romanian accounting regulation for financial leasing companies (non-banking financial institutions)

For Romanian leasing companies, regulated since 2006 by the Romanian National Bank, the accounting standards, issued by BNR are fully applicable starting with 2008. In December 2008 new accounting regulation were issued by BNR and replaced the old ones. According to order 13 issued by BNR (Romanian National Bank), non-banking financial institutions use the rules stated by the above mention order for measuring and evaluating assets. According to Order 13 / 2008, paragraph 83, assets are measured when first recognized, at one of the following values:

1. Acquisition cost in case they were bought;
2. Production cost in case they produced / obtained by the company;
3. Fair value if they were obtained for free (as a donation).

First, we must stress the limitation imposed by this paragraph: there is no rule for goods received in exchange. In fact, when we talk about cancellation of a leasing contract and returning the assets, some financial assets (namely the receivables - net investment in leasing and the current debt) are exchanged with another asset, or they are paid using the delivery of another asset, not a financial one.

Also, there are no rules for recognizing or derecognizing financial assets, or for evaluating the gain or loss in this situation.

From those reasons, Romanian financial leasing companies use a wide range of solution to measure the value of the asset regained, to classify it, and to derecognize the net investment in leasing when the leasing contract is cancelled.

3. International accounting regulation

Even if IAS 16 *Property, plant and equipment*⁵¹⁴ it is not applicable, we can look it up and inspire ourselves at least for a little bit. According to IAS 16, paragraph 24, if an item of property, plant or equipment was acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, the cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable.” So, for newly recognized assets in exchange of other assets, the fair value is to be used.

It is very important to stress the fact that in case of a cancellation of a leasing contract and returning the assets IAS 16 *Property, plant and equipment* is not applicable. The reason is that the asset that was the object of the contract, when returned, it shouldn't be classified as a fixed asset in the scope of IAS 16, but as a an inventory, in the scope of IAS 2 *Inventory*⁵¹⁵. IAS 16 defines an item of property, plant or equipment as being a tangible asset that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period.

IAS 2 define inventory as being assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

As we can see, for the leasing company the asset returned is not a fixed asset, because it will not to be used in the production or supply of goods or services, for rental to others, or for administrative purposes, but probably it will be also used for selling under new financial leasing contracts (most of the cases).

In rarely cases when the goods received because of the contracts cancellation are to be used either by the company or for operational leasing contracts (namely the leasing company intends to rent such assets to new customers) than the goods returned are to be classified as fixed assets, and not inventories.

If we search the answer to our question (how to evaluate the assets received) in IAS 39 *Financial Instruments: Recognition and Measurement*⁵¹⁶, paragraph 26 states that: “On derecognition of a financial asset in its entirety, the difference between:

- (a) the carrying amount and
- (b) the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognized in other comprehensive income [...] shall be recognized in profit or loss.”

In other words, the difference between the carrying amounts of the net investment in leasing and the debt recorded from monthly invoices and the value of the asset recovered from the lessee is to be recognize in the profit or loss account as an expense or revenue. The value of the asset returned should be the fair value, as no other value is available in this situation (we should take

514 IAS 16 Property, plant and equipment, IASB, www.iasb.org;

515 IAS 2 Inventory, IASB, www.iasb.org;

516 IAS 39 Financial Instruments: Recognition and Measurement, IASB, www.iasb.org;

into consideration that the assets was not recognized in the lessor's financial statements and the carrying amount of the financial asset is not relevant for the value of the asset returned).

In some cases, the lessor, even if it comes in the possession of the assets that was formally the object of the leasing contract, and even if the fair value of that good exceeds the carrying amount of the financial assets, it has a right, according to the contract, to receive from the lessee a price for canceling the contract. In this situation, a new financial assets is to be recognize, according to IAS 39 *Financial Instruments: Recognition and Measurement*. In this situation, the new financial asset is to be treated as a consideration received in exchange of the old financial assets (net investment in leasing).

In case the lessor intends to suit the customer for the unrecovered debt from the monthly invoices, then that financial asset is not to be unrecognized. Only the difference between the carrying amount of the net investment in leasing and the fair value of the regained asset is to be recognized in the profit and loss account.

4. Fiscal aspects

From a fiscal point of view, it is more acceptable to evaluate the asset regained at its fair value and to consider it a payment in exchange of the net investment in leasing, and to separately recognize the loss from the unrecovered debt from monthly invoices. The reason is that the Romanian Fiscal code allow the companies to deduct expenses with losses from customers in the same percentage as the previous deductible provision.

According to BNR orders, if a debt is not paid for more than 90 days, the Romanian leasing companies must recognize a 100% provision for that debt, but only for the capital and interest portions. Also, when the customers (lessees) were officially declared bankrupt, the lessor may deduct 100% from the lost debt and more important may recover VAT from the budget.

In cases in which the leasing companies evaluate initially the assets regained at the net carrying value of the financial assets related to the customers (net investment in leasing and debt form current invoices) and afterwards evaluate the fair value of the asset (this represents a very common method for Romanian leasing companies to evaluate the regained asset) the expense recognize with depreciation of the asset is non deductible. Plus, when and if finally the debtor is officially declared bankrupt, it is very difficult for the leasing company to adjust in its favor the VAT collected in the invoices issued to the lessee.

5. Conclusion

It is mandatory for Romanian leasing companies to fairly recognize the assets recovered form leasing contracts that were cancelled. The correct way to classify such assets is as a current assets, meaning inventory, unless the company has the intention to used it in the production or supply of goods or services, for rental to others, or for administrative purposes. In this situation the correct classification should be as fixed asset.

The value used for regained assets should be the fair value measured at the date of re-possession. If the leasing company doesn't derecognize the debt unrecovered (from invoicing) and finally the former lessee is declared bankrupt, VAT may be recovered from the budget and the entire expense with the lost debt is deductible.

Bibliography

1. IAS 17 Leasing IASB, www.iasb.org;
2. IAS 16 Property, plant and equipment, IASB, www.iasb.org;
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4. IAS 39 Financial Instruments: Recognition and Measurement, IASB, www.iasb.org;
5. BNR Order 13 / 2008;
6. Law 571/2003 Fiscal Code
7. Decision 44/2004 – Methodological norms for Romanian Fiscal Code