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LESSEES' RIGHT-OF-USE ASSETS – CONCEPTS, REQUIREMENTS AND PRACTICES[2]

This work is dedicated to the definitions of control introduced by the Conceptual Framework for Financial Reporting which defines assets recognition based on the understanding that assets are an economic resource and as such a bundle of rights. The concept of assets recognition based on the relationship with the provisions of property law is analysed and on this basis, the reporting, presentation and disclosure of the right-of-use assets in the financial statements of Bulgarian companies for 2021 are studied.

Keywords: Conceptual Framework; lease; right-of-use asset; lease liability; presentation and disclosure of leases
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Introduction

Globalization of the economy, internationalization of business, and the introduction of new technologies and digitization predetermine challenges for professional accountants. Changes in the business environment and economy are coupled with changes in accounting concepts and financial reporting rules. The requirements of the Conceptual Framework concerning the recognition of assets and the definitions of control introduced create new challenges for accountants and businesses (IASB, 2018). An asset is an economic resource and as such is a bundle of rights. Based on this concept, assets arising from legal rights held are recognized. Such are lessees' right-of-use assets, as well as the rights of recovery in case of sales with the right of return of the assets sold.

The purpose of this work is to analyse the concept of assets recognition based on the relationship with the provisions of property law and examine on this basis the reporting, presentation and disclosure of the right-of-use assets in the financial statements of Bulgarian companies. The subject matter of the study is the financial statements of companies applying the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS) for 2021.

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1. Accounting Concepts and Rules for Assets Recognition. Control as a Prerequisite for Assets Recognition

In terms of the law, items are separate physical objects. In some cases, legislation and jurisprudence have departed from the definition, and what has been stated is applicable not only to physical, but also to all objects of legal transactions (Kallwass, Abels, 2018, p. 256). According to the requirements of property law for a thing to exist, such thing must meet three conditions: it must be autonomous, material and able to serve the legal entities by satisfying legally relevant interests and to be placed under the authority of the legal entity (Dzherov, 2010, p. 35).

Most items are made up of clearly distinguishable components. In fact, there are many complex and elaborate things, such as a computer, a TV, a car, a building, a ship, etc.

If an item is attached to the property for a temporary purpose only or inserted into a building, then it shall not be treated as a component. The will of the inserter is decisive, so if a lessee installs certain items, he/she shall retain ownership of the elements installed (Kallwass, Abels, 2018, p. 258).

International Accounting Standard 16 – Property, Plant and Equipment (IAS 16) and Accounting Standard 16 – Tangible Fixed Assets (AS 16) show that assets that consist of materially distinguishable constituent parts (components) can be separated and each part shall be treated as an independent asset for the purposes of its amortization (IASB.2, 2022, IAS 16.44; Accounting Standard 16.3.2). This is necessary when component assets have different useful lives or provide different economic benefits to the enterprise, necessitating the use of different methods and rates of amortization.

A building, for example, can be divided into a number of separate physical components: a structure, a roof, an elevation system, an air-conditioning system, etc. Apart from the above, the components of a tangible fixed asset can be both physical and non-physical. In commercial shipping, for example, a ship as an asset also contains separate components. The components of a vessel that are separately identified include not only the distinguishable physical elements that will require replacement during the life of the vessel, but also those that will reflect the need for major repairs in the future. Insofar as the separation of components is required, it does not mean that the company will have to separate its vessels into multiple components. Some of these components may have substantially similar useful lives and residual values, in which case IAS 16 allows such components to be grouped together (IASB.2, 2022, IAS 16.45).

Marine vessels have a number of components that require replacement or overhaul at certain intervals during the vessel's operation. The frequency of repairs shall be in accordance with the rules and regulations relating to the vessel's classification. Due to the requirements associated with the individual components, it is imperative that they be depreciated using different useful lives and residual values. Importantly, it is often not possible to change engines before the ship is cut. An engine has the same useful life as the hull of a ship (Deloitte, 2021, p. 11).

Composite depreciation is defined as the process of averaging the useful lives of a number of units and depreciation accrual on the entire set as if it were a single operating unit. A component approach is preferable for a number of reasons:

a. A component accounting allocates more accurately activity costs and profit over periods;

b. The composite life cannot be determined with a high degree of accuracy and may not reflect the weighted average useful life of all components of the asset;

c. The combined approach may hide inaccurate estimates of expected useful lives over long periods;

d. The approach may not be able to adjust for changes in the use of the asset or other factors affecting the actual useful life compared to the expected useful life;

e. Control over tangible fixed assets may be reduced because detailed records cannot be used;

f. If individual components become inoperable, the depreciation of those nonoperating units cannot be determined with the same accuracy as if those units were individually depreciated (AICPA, 2001, p. 44).

A part of the daily maintenance and repair of the ship is carried out by the crew members. However, some repair operations cannot be carried out by the crew because they require special tools and special technical knowledge and skills, and these are entrusted to specific ship repair and shipbuilding companies. Added to that, the vessel will require seaworthiness checks, underwater hull inspections, intermediate and special surveys within its estimated service life.

Each of these inspections and repairs may qualify for capitalization under the criteria of IAS 16. This standard requires that significant repair costs (dry dock costs and special surveys) are capitalized as part of the asset and amortized until the occurrence of the next repair (Deloitte, 2019, p. 512; KPMG, 2013, p. 3).

This means that the basic accounting principles are confirmed and the component approach is contradicted:

- The confirmation is related to the importance of complying with the principle of comparability of revenues and costs, since the costs of major repairs refer to more than one accounting period and therefore must be amortized according to the period covering this repair until the next dry dock. This is also the period during which future economic benefits shall be gained;
- A contradiction to the component approach, which is not applicable to this case. As detailed in IAS 16, some components of property, plant and equipment may need to be replaced at regular intervals. In this case, the parts replaced should be written off from the carrying value and a cost at the price of the new parts – which is impossible in the case of dry dock and the special inspection – should be recognized (Hendawi, 2018).

Title (ownership) is a comprehensive, fundamental and absolute right to the property enforceable against everyone, not only against specific persons, unlike the obligation rights

(Dzherov, 2010, p. 80, 85). Title is the legal possibility of the owner to carry out transactions of disposal of his/her property. This is the ability of the owner to use and sell his/her property, donate it, replace it, mortgage it, and etc. The owner may transfer his/her right in whole or in part to a third party. He/she can reduce the scope of his/her right and establish limited rights in rem over his/her property to the benefit of a third party (*superficies or easement*). The title is also expressed in the possibility of actual disposal of the property.

The content of the title (property right) covers three actual and legal powers: to dispose of, to possess and to use the property (Dzherov, A., 2010, p. 85). If the entity owns any of these rights, it can recognize it as an asset. These entities' rights may be recognized as independent asset. However, for accounting purposes, related rights are often treated as one unit of account, as an individual asset (IASB, 2015, 4.11).

"An asset is a current economic resource controlled by the company as a result of past events" and "an economic resource is a right that has the potential to produce economic benefits" (IASB, 2018, 4.3, 4.4). The value of the economic resource depends on the possible economic benefits to be derived from it in the future, but as such it is rather a right that provides this opportunity, not the evaluation of future benefits to which this right will contribute for (IASB, 2018, 4.17).

According to the Conceptual Framework, the asset is not identified by the particular physical object, but represents the existence of rights over said object. It is also the understanding of the real right that the economic resource is not the physical object, but the bundle of rights associated with it. With a view to practical expediency, all rights, as elements of ownership of a physically distinguishable object, are taken into account as a separate reported object, ignoring the separate reporting of the rights over such asset. This ensures a more understandable presentation of the rights to the asset (IASB, 2018, 4.12).

The concept of control is based on the ownership as a legal opportunity for a person to possess, use and dispose of a particular property. Possession, use and disposal are actual and legal powers related to ownership. Possession is the right to exercise the actual power over the property. It is considered that an owner cannot use the property unless he/she owns it. The right to use is the right to derive the benefits from operating the property and to acquire income from it. The right to dispose of a property is the ability of the owner to establish any legal relationships regarding his/her property. The owner is the one who decides whether or not and how he or she will exercise the individual rights. He/she may have granted some of his/her powers to others, but still remains the owner. The title is absolute because the owner has the opportunity to prevent other persons' encroachment against the property and has the right to request from them to refrain from any actions with respect to such property.

The concept of control is the ability of a company to exercise its rights arising from the ownership of economic resources (IASB, 2018, 4.19). Assessment of the existence of control provides for the economic resource to be identified, which the entity will recognize and report as an asset. Control of economic resources gives the opportunity to guide the use of such resource and at the same time to acquire the economic benefits from such use. The ability to manage the use of an economic resource as well as to obtain economic benefits from it is based on the existence of control. It follows that if one person controls a particular economic resource, it is not possible for another person to control the same resource.

The definition of asset in the 2018 Conceptual Framework once again requires the economic resource to be "controlled by the company". Control definitions were also introduced. They are based on the control definitions contained in IFRS 15 – Revenue from contracts with customers (IFRS 15), which contains the asset control indicators and in IFRS 10 – Consolidated Financial Statements (IFRS 10), which determines control over a subsidiary company. Although the definitions in these standards differ, they are based on the assumption that an entity has the ability to arrange the use of an asset (or enterprise) to obtain economic benefits (or for return from the investment).

When developing the concept of accounting for tangible assets as a set of rights, it should be noted that it does not correspond to the current understanding and practice of reporting. The understanding of the essence of the asset as a bundle of rights (which is also the presented understanding of property law) logically leads to these rights to be recognized as separate assets.

IFRS 15 uses five indicators, which give reason to assume that the client has the ability to manage the use of a particular asset and on this basis to receive the benefits associated with its use (IASB, 2022, IFRS 15.38). The time when the client acquires control over the promised asset is the time when the enterprise satisfied the obligations assumed, taking into account the requirements for control. On the other hand, we believe that it would be wrong to claim that these are accounting criteria only. Therefore, they cannot be detached and made independent from the legal elements of ownership. Not all indicators must be met for the entity to conclude that control is available. The management of the enterprise must use its production and economic experience and the business model adopted to determine whether or not the factors (or part of them) prove that the company exercises control. The assessment must be directed to a specific object and a specific transaction. When making the assessment of the existence of control, the entity takes into account the existence of the control indicators as follows:

1. **An entity has the right to receive payment for the asset –** if the client has taken the obligation to make a payment for a certain asset, it is reasonable to assume that the actual power and right to determine the manner of operation and to receive all income and other benefits from such asset were granted in return. A major criterion for recognizing sales revenue is the likelihood of receiving the sales amounts. This condition was laid down in IAS 18 (repealed) as well as in IFRS 15 and is required regardless of the fact that the principle of accrual is applied. One of the conditions to be met by contracts according to IFRS 15 is the likelihood of collecting the remuneration related to them.
2. **The enterprise is the legal owner of the rights to the asset** – the right of ownership is the ability of the owner to determine how the property shall be operated and how shall the benefits of such property be gained, as well how income shall be derived therefrom. The owner is the one who decides whether or not and how he/she will exercise his/her rights. He may have granted some of his rights to others. The title (property right) is absolute because the owner has the power to require others to refrain from actions with respect to the property. The transfer of ownership of an asset is usually bound by the transfer of control over it. If an entity reserves its title over certain property as a protective measure only, until it guarantees payment from the client, this cannot be a reason to state that the client has no control over the asset (IASB, 2022, IFRS 15.38.b).

An entity that holds legal property rights is usually the party that runs the use and receives the benefits from an asset. Ownership of the title reflects the owner's ability to dispose of the asset – to sell it, to mortgage/pledge it, and etc., indicating that the holder has control over it.

Depending on the type of sale, the sale contract should be concluded in the relevant form for validity. Commercial transactions are usually defined as informal. The [Bulgarian] Commerce Act stipulates that "written or other form is required for the validity of the commercial transaction only in the cases provided for by the law" (Commerce Act, 2022, Art. 293). The ordinary written form has been introduced in a number of places in the current legislation as a condition for the validity of the transaction. In order to conclude a sale contract in all other cases, it is sufficient to reach an agreement between the parties, which may be oral. The written form is recommended with a view to a possible legal dispute between the parties and in order to prove certain facts. The legislation introduces the requirement for compliance with a certain qualified written form as a condition for validity – a written form with Notary Public's certification of the signature, a written form with Notary Public's certification of the date, a written document in the form of a notarial deed, and etc. A special format is required, for example, for the sale of real estate or a right in rem over real estate, for the sale of registered vehicles, trailers, wheeled tractors and motorcycles with an engine volume of over 350 cm^3, for the sale of a ship, an aircraft and others. US accounting standards also provide requirements for the form of the contract in accordance with the applicable jurisdiction "Some arrangements may require a written contract for compliance with laws or regulations in a particular jurisdiction and these requirements must be provided to determine a contract. The negotiation must be legally sustained in order to be within the scope of the standard model" (EY.1., 2020, p. 21).

3. **The entity has transferred the possession of the asset** – possession of the asset is an indication that the client has the ability to determine the way to use the asset and receive the benefits from its operation. This also implies the actual power of the owner to limit other persons' access to these benefits. Physical possession may not be sufficient to provide control over an asset. Contrary to ownership (the legal power), possession is a factual power over the property (Kallwass, W., Abels, P., 2018, p. 262). Legal possession is important in property law. For a legal possession to be available, six other elements must also be met, such as to be: constant, uninterrupted, calm, clear, undoubted and with an intent of holding the thing as its own (Dzherov, A., 2010, p. 72). The main element is the intention to hold the thing as its own. Legal possession is a legal fact, and as such it gives rise to legal consequences. They are expressed with the ability to seek legal protection of the possession (Dzherov, A., 2010, p. 72).

The possession of an asset does not yet prove the existence of control. This will be the case in contracts with a redemption clause and in consignment contracts. Conversely, it may also be valid in some contracts that provide for invoicing and detention, the entity may retain the physical possession of an asset that is under the control of the client or is already his/her property. Usually, the physical possession of the asset is an indicator of which person controls the asset, suggesting that it provides that person to determine the manner of use, as well as to receive the benefits from the possession. Of course, the clauses in the contracts should be analysed in order to conclude whether or not the physical possession grants control over the asset.

When the entity delivers the goods (production) to another entity in order to be sold to end customers, it must be considered whether or not the receiving entity shall acquire control at the date of receipt. In the case of delivery of consignment goods, the recipient is usually not required to pay until the sale of the product to a customer is effectuated. In such cases, the seller (or the consignor) reserves the ownership of the goods, and the counterparty (or the recipient) acts as a sales agent.

4. **The customer bears the significant risks and ownership benefits from the asset** – the transfer of significant risks and benefits over the items sold is important for determining the time when the entity has transferred control to the buyer. If during the study of the circumstances of the transfer, of the risks and benefits of ownership it is established that the entity has still maintained to a great extent the risks and benefits of ownership, the transaction cannot be considered as revenue generating (Wiley, 2011, p. 183). During the period from the entering of the contract to the transfer of the property, the risk of accidental loss of the individually determined property is borne by the new owner – the buyer. If the items are fungibles, the risk shall pass on to the buyer from the time the goods are specified or delivered to the buyer (Obligations and Contracts Act, Art. 186A). According to the civil legislation, the ownership shall pass to the buyer with the transfer (usually with the receipt of the property) of the property sold – the danger of accidental loss and spoilage of the property sold shall pass on to the buyer (breaking, spoilage, theft, and etc.). The thing perishes for the owner (*res perit domino*) principle applies. Both the transfer of the benefits and the risks associated with the property arise from the transfer. There is sufficient practice under the application of IAS 18 that has developed in the years of its application, and in no way, it can be claimed that IFRS 15 has introduced this criterion. There is no unanimity on the matter of the importance of passing the risk of loss. According to some authors, passing the risk of loss is crucial for the importance of recognizing sales revenue (Adler, H., During, W., Schmalz, K., 1971, p. 494). According to other authors, recognition of realization is unfeasible until the danger of loss has passed away. The claim should be generally recognized when the seller has fulfilled everything necessary for the performance of the contract and the danger of accidental loss or damage has passed on to the buyer (Coenenberg, A., Von Wysocki, K., 1983, p. 401). According to a third group of authors, the passage of risk is just an ancillary criterion and it is only decisive in the case where the risk of loss is significantly large (Hachenberg, M., Ulmer, P., 1989, p. 42).

The obligation to hand over the property to the buyer in the state in which it was at the time of the sale arises for the seller upon the entering of the sale contract. The buyer is obliged to receive the goods and pay the price at the same time as the transfer of the goods is made or within the deadline agreed by the parties. The possession of the risks and benefits associated with the asset can be considered an indicator of the management capacity of the entity, for the use of the asset and for obtaining economic benefits from its operation,

5. **The entity has accepted the asset** – the customer's acceptance of the asset may indicate that the acceptance of the thing, which is a formality, does not affect the conclusion of whether or not control has been transferred. Handing over the object is not a condition for entering of the contract, but a consequence of the sale. An acceptance clause that applies to goods meeting certain conditions and specifications may allow the transfer of

control and the generation of revenue once the entity demonstrates that these conditions are met before the goods are shipped. An acceptance clause that refers to certain specifications is not just a formality, as the entity has to ensure that these requirements exist and will be accepted by the customer. Acceptance should not be considered a formality even if the product sent is unique, since there is no analogue to compare with.

The customer has no control over the products received during the trial period until they are accepted, even if there is no obligation to pay for them. The concept of acceptance is used in civil law and is treated as the seller's obligation to hand over and the buyer's obligation to accept the item purchased. If the buyer is obligated to assume actual possession of the goods, the acceptance is covered by the acquisition of the right of ownership. In the event that the item purchased has been delivered and if the buyer has already accepted it, the risk of loss can no longer arise for the seller. In case the buyer delays the acceptance at the buyer's fault, recognition of revenue and profit shall depend on whether or not the seller shall protect his/her rights from such delay.

2. Lessees' Right-Of-Use Assets – Regulations and Practice

In recent decades leasing has become an important financing tool replacing bank loan financing. A lessee acquires the right to use an asset without having to immediately pay its purchase price. Ultimately the lease may stand for a purchase combined with financing from the lessor. The rights or assets acquired as a result of the lease contracts should reflect the economic content of the transactions and enable the parties to the contract to reflect accurately and honestly the financial situation with a view to these transactions. Operations may be accounted for as an ordinary lease, where the lessor acting as the legal owner accounts for the subject matter of the lease as an asset and depreciates it over the estimated period of practical use, and the lease instalment that has been agreed upon is periodically recognized as a rental income. The lessee, on the other hand, shall periodically report the lease payments as an expense. Such reporting however seems inadequate if other characteristics of the lease contract exist, for example:

- The lessee is granted the right to operate the leased asset for the period specified in the contract, which approximately corresponds to the probable useful life of the asset;
- The total contract lease to be paid is similar to the original fair value of the asset leased.

Although the lessee does not acquire legal ownership rights, he/she cannot be removed from the economic ownership and can use the asset for most of its expected useful life. And yet, this asset is recognized as an asset in the statement of financial position (financial lease) or is excluded from it (operating lease).

The financial lease is reflected as a debt-financed purchase in the lessee's balance sheet, not only the leased object is entered, but also the corresponding obligation to pay for it. As a result, assets increase, but more important is the impact on the liability of the balance sheet, as liabilities also increase. Due to the negative impact on the credit rating, the lessee might be interested in reporting and presenting the lease as an operating lease.

The purpose of the repealed IAS 17 Leases, was to identify when a lease is economically similar to the purchase of the leased asset, the lease is classified as a financial lease, and the lease is recognized in the lessee's balance sheet. Other leasing contracts, where there is no similarity to the purchase of the asset, are classified as operating leases and are not reflected in the balance sheet of the lessee's company – they are off-balance sheet leases. With a view to such policies of an on-balance sheet or off-balance sheet reporting and related information in the annual financial statements, the accounting rules for reporting, presentation and disclosure of the lease have changed. Unlike the 'all or nothing approach', almost all assets arising from rights under lease contracts will be recognized in the lessee's balance sheet.

A new control concept based on economic benefits is applied to asset accounting:

- economic benefits from ownership – the benefits of the lessor;
- economic benefits from ownership and operation – the benefits of the lessee having the right to direct the use of the asset rather than being just an operator.

In the case of an operating lease, the following treatment is applied – the lessee under an operating lease recognizes the right to use the asset leased as a right-of-use asset for the term of the lease (IASB.1, 2022, IFRS 16.22). In order to recognize a right-of-use asset, it is necessary that the lessee is able to direct the use and operation of the asset throughout the contract duration, as well as to be able to make decisions related to the conditions and objectives of the operation, which are predetermined (IASB.1, 2022, IFRS 16.B24).

The rights to operate the leased assets are capitalized. The initial valuation of such assets is carried out by calculating the present value of the lease payments throughout the term of the lease. The distinction existing in IAS 17 between an operating lease and a financial lease is eliminated by recognizing a lease asset (representing a right-of-use asset throughout the term of the contract) and a lease liability (representing the obligation to pay the leases/rents).

The new concept introduced by IFRS 16 Leasing (IFRS 16) and the control model introduced for identifying lease relationships leads to an accounting of rights over the leased asset by the controlling party – the lessee. At the same time, the asset leased is also reflected in the statement of financial position of the owner – the lessor, who reports the leased assets, as it has been until now.

The asset that is the subject matter of the lease agreement should be individually specified in the contract and must be specifically identified, or this should be done at the time when it is delivered to the lessee. (Pellens, B., R. Fulbier, J., Gassen, T. Sellhorn, 2017, p. 780).

The Accountancy Act regulates that companies in Bulgaria shall prepare their annual financial statements by applying the National Accounting Standards (NAS). Certain companies prepare their financial statements based on International Accounting Standards (IAS), as required by the Accountancy Act (Accountancy Act, 2021, Art. 34). The National Accounting Standards applicable in Bulgaria define an asset as "a resource controlled by the entity as a result of past events, from which future economic benefits are expected to flow to the entity" (National Accounting Standards). Therefore, lessee entities applying the NAS report contracts that are classified in the operating lease category as off-balance sheet leases and do not recognize them in the company's balance sheet (Accounting standard No. 17).

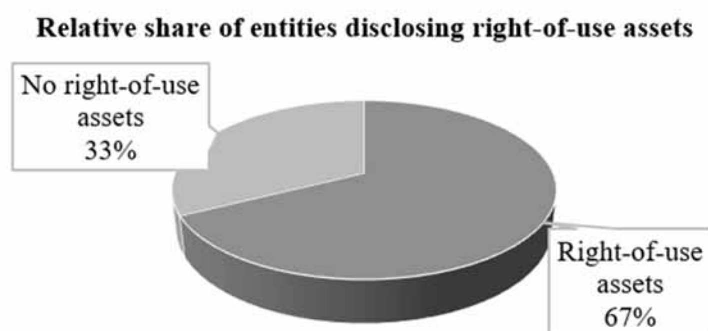
In order to analyse the application of the new rules contained in IFRS 16, this study includes companies applying IAS/IFRS.

The annual financial statements of public companies for 2021 were studied with the aim of establishing the application of the lease accounting rules by the lessees, the method of application, as well as the selected options available in IFRS 16. These are the companies in the index of the Bulgarian Stock Exchange stock exchange – BGBX40 (BSE-Sofia.bg). The study includes 40 companies applying IAS/IFRS in their individual financial statements. The study covers the individual financial statements to avoid the elimination of leasing relationships between the entities being part of an economic group. The study was mainly aimed at answering the following questions:

- What part of the entities present right-of-use assets?
- How significant are right-of-use assets compared to non-current assets and total assets?
- How significant are the lease liabilities compared to the liabilities of the relevant company?
- Which of the options available in IFRS 16 has the entities chosen regarding the right-of-use assets?
- How are the right-of-use assets presented and disclosed in the companies' financial statements?

Within the framework of the study, 27 of the entities or 67 percent of all the entities studied disclosed in their annual financial statements the presence of a right-of-use asset.

Figure 1. Relative share of the right-of-use assets vs non-current assets

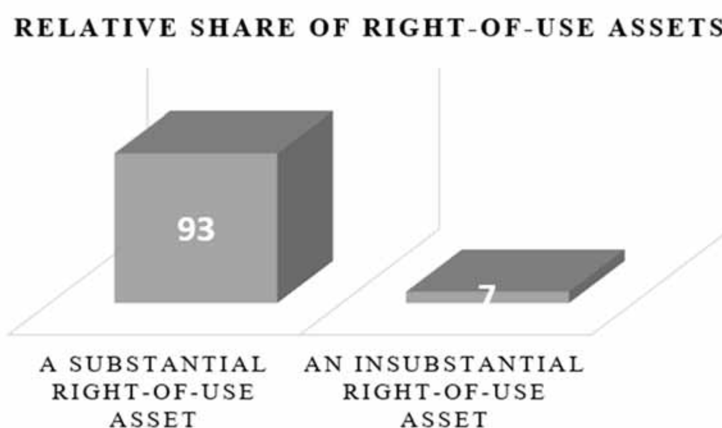


The lessee entities reporting the existence of right-of-use assets disclose in their explanatory notes the existence of the prerequisites for the existence of a lease control.

For the majority of the entities studied – approximately 81% of them – the lease assets recognized were not a significant part of their fixed assets, and for some of them – for 19 % of them – the lease assets recognized represent a significant part of their non-current assets.

The amount of leased assets compared to the balance sheet amount of assets is significant for only 7% of the twenty-seven companies studied (reporting leased assets).

Figure 2. Relative share of right-of-use assets vs non-current assets



Right-of-use assets at the beginning of the lease should be valued at cost (IASB.1, 2022, IFRS 16.23).

The companies studied disclose compliance with the rules for the valuation of the right-of-use asset specified in IFRS 16 at the inception date. The companies specify that they evaluate the lease liability as at the inception date at the present value of the lease payments that have not yet been paid at that date. Lease payments are discounted by using:

- the interest rate stipulated in the lease contract; or
- if the interest rate cannot be easily determined, the lessee's interest rate is used (IASB.1, 2022, IFRS 16.26).

Disclosures show that a differential (internal) interest rate is usually used for the right-of-use assets, for which no acquisition option (operating lease) is available or the interest rate stipulated in the contract for the assets where a significant transfer of risks and benefits (finance lease) is available.

Once the right-of-use assets are recognized at the inception date, they are evaluated using the cost model. It is permissible for the right-of-use asset to be evaluated subsequently by applying the valuation models provided for in IFRS 16.34 and 16.35.

If the company has chosen the acquisition cost model for the subsequent valuation of the lease asset, the right-of-use asset is evaluated at acquisition cost, less the accumulated depreciation and impairment losses accrued, and also by taking into account the adjustments caused by the change in the lease liability (IASB.1, 2022, IFRS 16.30).

When the lessee applies the fair value model to its investment property, he/she should also apply the fair value model to the right-of-use assets that are treated as investment property in IAS 40 (IASB.1, 2022, IFRS 16.34).

The lessee has the right to choose with respect to the right-of-use assets that relate to a class of property, plant and equipment to which the lessee applies the revaluation model set out in IAS 16. The lessee may apply the revaluation model to all right-of-use assets that relate to this class of property, plant or equipment (IASB.1, 2022, IFRS 16.35).

Therefore, for property, plant and equipment:

- if the class of own assets to which the right-of-use assets relate is accounted for by using the cost acquisition model, then this model must also be applied to the right-of-use assets;
- if the asset class to which the right-of-use assets relate is valued under the revaluation model set out in IAS 16, the lessee may choose:
  - to apply the fair value for the subsequent evaluation of the right-of-use assets;
  - to apply the acquisition cost model for subsequent valuation of the right-of-use assets.

In reality, the accounting model to be followed for right-of-use assets that are investment properties is determined by the lessee's accounting policy and the lessee's choices made for the investment properties owned.

85 % of the companies studied have disclosed that they apply the acquisition cost model for subsequent valuation of the right-of-use assets.

Right-of-use assets valued under the cost model should be depreciated by applying the requirements of IAS 16 as follows:

- if the lease contract transfers ownership of the leased asset to the lessee until the expiration of the lease term or if the cost of the right-of-use asset indicates that the lessee will exercise a purchase option, the asset should be depreciated over its useful life. Therefore, if ownership of the leased asset is transferred to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation shall be based on the asset's useful life;
- if the above-mentioned conditions are not present, the right-of-use assets shall be depreciated until the earlier date – of the end of the asset's useful life *or* of the end of the term of the lease agreement (IASB.1, 2022, IFRS 16.31, IFRS 16.32).

These rules are disclosed by all the companies studied (reporting lease assets), depending on the type of lease – the useful life of the asset under the terms of a financial lease or until the earlier date – the end of the useful life of the right-of-use assets or the end of the lease term.

The companies studied have disclosed that they apply the straight-line method of depreciation of the right-of-use assets, and this is true for about 85 % of the companies.

A lessee may choose not to apply the requirements of IFRS 16 for:

- Short-term rental contracts. These are leases with a term of less than 12 months. (IFRS 16, Appendix A). If the lease contract contains a purchase option, it cannot be treated as a short-term lease.

Twenty-six of the companies studied, or 96 percent of them, disclosed that they have chosen not to apply the requirements of IFRS 16 for short-term leases and instead reflect the straight-line method of rent expense for the current reporting period.

- A lease where the value of the leased asset is low, based on its cost as new, regardless of its age. Lessees are not required to recognize low-value lease assets or liabilities. The IASB provided a threshold of $ 5,000 regarding the value of the leased asset (when new) to help companies identify leased assets that could be covered by the exemption (IASB, 2016, p. 19, p. 39). This solution is optimal for practical reasons, but is a departure from the materiality principle applied in other IAS/IFRS. Assets that are highly dependent on or highly interconnected with other assets are not allowed to be qualified as low-value assets.

26 of the companies studied, or 96% of them, disclosed that they have chosen not to apply the requirements of IFRS 16 for leases where the underlying asset is of low value and instead reflected lease expenses for the current reporting period on a straight-line basis.

The lack of disclosure (for short-term leases and leases where the underlying asset is of low value) in some of the companies may also be due to the absence of such contracts.

After the inception date, the lease liability shall be valued by:

a) increasing the book value so as to reflect the interest on the lease liability;

b) reducing the book value so as to reflect the lease payments made; and

c) revaluating the book value so as to reflect any revaluation or changes in the lease or to reflect revised in-substance fixed lease payments. (IASB.1, 2022, IFRS 16.36).

Liabilities under lease contracts are measured, like other financial liabilities, on an ongoing basis using the effective interest method. The lease liability is evaluated so that its carrying amount is equal to the amortized cost. Interest expenses distributed over the term of the lease are reflected as an increase in the liability, and payments provided for in the contract are reflected as a decrease of such liability. The lease liabilities of the companies studied compared to the liabilities in the balance sheet constitute a significant part for nearly 15 % of them, and for long-term lease liabilities, the ratio is about 11 %.

The interest on the lease liability in each period of the term of the lease agreement is the amount of the interest calculated on the balance/principal amount of the lease liability. Interest rate is the discount rate used in the initial valuation of the lease liability or the revised discount rate.

The costs for interest accrued on the 2021 lease presented in the profit or loss account or other comprehensive income statements compared to reported expenses for the period is immaterial for all the companies studied.

Lease contracts may contain lease and non-lease components to which different accounting recognition models apply. Non-lease components are items or activities that are associated with the promise to transfer a good or service to the lessee. IFRS 16 requires each individual component of a lease to be identified and accounted for separately. The right to use an underlying asset under the lease agreement provides the lessee with the opportunity to operate it individually or together with other goods and services. These criteria are similar to the criteria contained in IFRS 15 for analysing the distinctiveness of goods or services provided to customers.

Amounts owed by the lessee that are not related to the transfer of goods or services to the lessee – such as costs and fees for administrative services, taxes and insurance) should not be treated as separate components of the contract – they are included as part of the amount to be allocated to the identified components of the lease contract (IASB.1, 2022, IFRS 16.B33).

The remuneration agreed in the lease contract should be allocated for each component identified – both leasing and non-leasing. IFRS 16 provides the lessee with the possibility to estimate the individual prices of the lease components, as the lessee may not have information about the lessor's stand-alone prices.

IFRS 16 contains separate rules for lessees and lessors.

Lessees allocate the amounts due under the contract between the lease and non-lease components based on:

- the individual price of each lease component; and
- the individual total cost of the non-lease components.

Prices are determined on the basis of the lessor's or other supplier's price offer as a stand-alone price for the component at issue. The lessee determines the price by using mainly observable information instead. Lessors must allocate the contract consideration among the lease and non-lease components in accordance with the allocation rules required by IFRS 15. Furthermore, given the likelihood that the lessee will not have complete information about the lessor's pricing model, the IASB has provided an exemption from the requirement to separate non-lease components. When practicable, the entity shall account for the combined lease and non-lease component as a single lease component. This choice of policy should be made in according with the class of the underlying asset. If the components are not separated, the lessee will recognize a greater liability for the lease and this expedient option is likely to be used only when the service components are not material (PWC, 2017, p. 7).

If component separation is applied, the lease components shall be accounted for in accordance with IFRS 16, while the non-lease components shall be accounted for by applying other relevant standards. The lessor accounts for non-lease service components by applying the rules of IFRS 15.

The expediency-based method of separating lease and non-lease components is an option provided for lessees only, and not for lessors.

Individual identified lease components that have similar characteristics can be accounted for as a single portfolio. The application of this understanding is shown in the illustrative examples accompanying IFRS 16 (IASB.1, 2016, Illustrative Example 12).

A predominant part of the companies studied – 21 or 78 % of them – have disclosed that they benefit from the relief of not separating the lease and non-lease components. Only 6 of the companies or 22% of them have adopted a policy of component separation.

The lessee must apply IAS 36 Impairment of Assets to determine whether or not the right-of-use asset is impaired and account for identified impairment losses (EY, 2020, p. 67). All the companies studied disclose that right-of-use assets are subject to an impairment test.

The lease asset – a right-of-use asset – is a non-current non-financial asset and the lease liability is part of the current and non-current financial liabilities, depending on the term of the lease payments. The short-term lease payables of the companies studied compared to the total lease liabilities make up an average of about 33 %, and this percentage varies widely for the individual companies from 6 % to over 70 % and depends on the year and the term of the contract.

The book value of the leased asset under an individual lease usually reduces faster than the book value of the lease liability. The explanation for the faster depreciation (value reduction) of the leased asset is that it is generally depreciated using the straight-line method, and the lease liability is reduced by the amount of lease payments made and increased by the interest accrued for the period. Therefore, although the amounts of the lease asset and the lease liability are the same at the beginning and at the end of the lease, the value of the asset is usually lower than that of the liability over the life of the lease.

The ratio of the right-of-use asset and the lease liability is greater in value for 48 % of the companies studied, and for the remaining 52 %, the lease liability is greater.

The lessee presents the right-of-use assets separately in the statement of financial position or discloses them in the notes to the financial statement. The lessee presents them as follows:

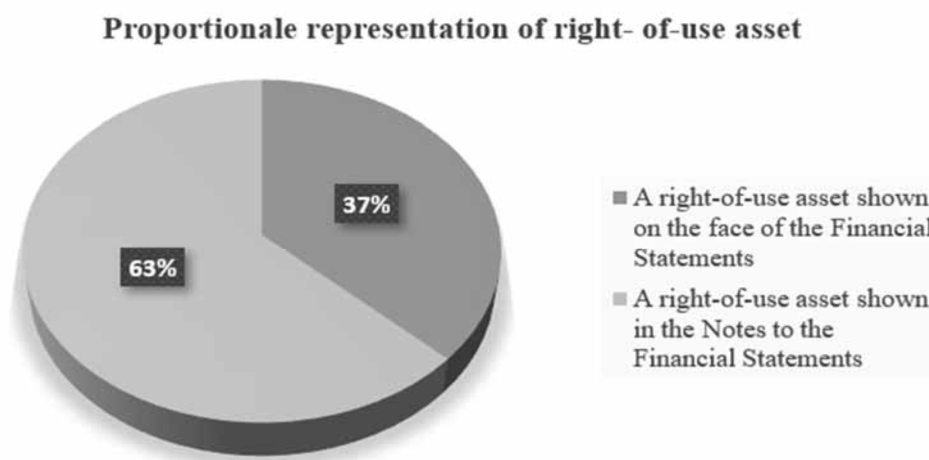
- lease assets are shown separately from other assets; and
- lease liabilities are shown separately from other liabilities.

The lessee presents in the statement of financial position or discloses in the explanatory notes:

- the right-of-use assets as a separate item.
- if the right-of-use assets are not presented on the face of the statement of financial position as an item, the lessee should group them together with the other assets by including them in the same item in which the assets would be presented if they were owned. It should be disclosed which items in the statement of financial position include those right-of-use assets (IASB.1, 2022, IFRS 16.47).

The companies studied used both approaches – presentation of the right-of-use assets on the face of the statement of financial position or in the information of the explanatory notes. 37 % of the companies present the right-of-use assets on the face of the statement of financial position.

Figure 3. Relative share of companies presenting the right-of-use assets in the statement of financial position and in the explanatory notes



The lease liabilities are also presented separately by part of the companies in the statement of financial position as lease payables and are divided into the current and non-current sections – as current and non-current liabilities. The predominant part of the companies presents the lease liabilities as part of the commercial obligations, their disclosure, including in the short-term and long-term section of the statement are indicated in the respective explanatory notes annexed.

Most of the companies present in the explanatory notes a separate statement of right-of-use assets providing data on the initial value, changes in book value, depreciation accrued for the period, accumulated depreciation, book value, etc. As a rule, this is the case with companies that have chosen to present the right-of-use assets on the face of the statement of financial position. Another part of the enterprises presents the right-of-use assets as part of the explanatory notes about property, plant and equipment or as a separate report in addition to the report on property, plant and equipment.

The requirement for separate presentation of right-of-use assets does not apply to right-of-use assets classified as an investment property, which should be presented in the statement of financial position as investment property (IASB.1, 2022, IFRS 16.48). These companies have presented them as investment properties in a separate report.

Operating lease expense, which is accounted for on a straight-line basis under operating leases, when applying IAS 17, is now the amortization expense of the estimated lease rights recognized as assets (included in the operating expenses) and interest expense on the lease liability (included in the financial expenses). The amortization rate is usually the same, and interest expense decreases over the lease term as lease payments are made thus reducing the principal. This leads to a reduction in overall costs when the individual lease is nearing the end of the agreed term. When applying IFRS 16, the sum of interest expenses and

depreciation expenses during the first half of the lease term is usually higher than the linear expense for operating leases recognized when applying IAS 17. Conversely, for the second half of the term of the lease – the sum of interest expense and depreciation expense is generally expected to be lower than the straight-line expense for operating leases (IASB, 2016, p. 44).

That is why the profit before interest (operating profit, EBIT) is higher compared to operating profit when applying IAS 17. The amount of the increase in operating profit and financial expenses depends on factors such as the importance of the lease to the company, the duration of the lease contracts and the discount rates applied (IASB, 2016, p. 45). Variable lease payments are classified as operating expenses because they are not included in the initial determination of the lease liability.

In the statement of profit or loss and other comprehensive income, interest expense on the lease liability must be presented separately from the amortization expense of the right-of-use asset and it is a component of the financial expense, which, in accordance with IAS 1 Presentation of Financial Statements, is presented separately in the statement of profit or loss and other comprehensive income (IASB.1, 2022, IFRS 16.49).

As a result of the study, it is not possible to express a definite opinion on whether or not and to what extent the introduction of the new rules has led to a different presentation of the financial status of the entities studied, since the rules for financial leasing have not changed. Only about 15 % of the companies presented the right-of-use assets with purchase options and right-of-use assets under an operating lease contract separately in the explanatory notes.

Conclusion

The balance sheet presentation of the right-of-use assets under the operating lease contracts created additional requirements for the organizations and their accounting. Given the existence of a large number of lease contracts, this posed serious challenges to the companies' management and their accounting staff. Despite the undeniable improvement in comparability between companies that lease assets and companies that receive loans for the purchase of assets, the accounting work was far from small when the requirements of the standard were initially implemented. The IASB expected that once a company had set up its systems to provide the information required by IFRS 16, the costs would be only marginally higher than those incurred in applying IAS 17. However, it is expected that the benefits and the information that will be available from the implementation of the new rules will exceed the costs of achieving them. (IASB, 2016, p. 38). On the other hand, the drafters of IFRS 16 probably did not expect such changes in lease contracts as were caused by COVID-19. In 2020 the lessees, who applied the new requirements in 2019, already had to take into account changes in the lease contracts, which given the existence of so many contracts was a difficult task, even an impossible one. On this basis, the IASB undertook to amend IFRS 16 related to COVID-19, which would allow lessees to apply a practically expedient treatment and therefore its introduction can be positively evaluated, since the users of the financial statements are not deprived of useful information (IASB, 2020).

On the basis of the research conducted, which by no means purports to be exhaustive and does not allow for any general conclusions, we can conclude that the companies studied have applied the rules for accounting for right-of-use assets and lease liabilities using one or another option for their presentation, subsequent evaluation, amortization, and etc. The conclusion that needs to be drawn is that the companies studied have applied IFRS 16 in its entirety and have presented in their individual financial statements the necessary and required information that is useful as a way of presentation for the users of the financial statements. However, we cannot confirm with certainty that the information presented for the above reasons justifies the costs of its achievement.

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