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COSTS OF CAPITAL AND OPERATING LEASES

Abstract: Capital and operating leases are the most important types of leases. Both of them result from legal and tax aspects. The most important legal regulations concerning lease agreements can be found in the Civil Code, Income Tax Act, Goods and Services Tax Act, Accounting Act and International Accounting Standard 17 Leases ("IAS 17 Leases"). Regulations concerning lease agreements require the appropriate classification. This classification ought to contain closure effects of an agreement recorded in account books, which must arise from legal provisions. Lease asset is treated by these regulations in various ways, what results in differences in account books as well as different distribution of lease costs and ownership of the asset after termination of the agreement. The aim of this article is to present costs of capital and operating leases in the context of their recognition in the accounting system, in particular in accounting records of an entity. The article uses the method of literature studies (national literature, including scientific articles and legal acts). Moreover, an analysis method has been used. This article is an attempt to answer the question of how to present capital and operating leases in account books of both the lessee and the lessor, in context of guidance deriving from the Accounting Act.
Keywords: lease, the Accounting Act, international accounting standards, accounting records of operating lease, accounting records of capital lease.
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Introduction

Lease is a form of financing the growth of enterprises by external sources. What is more, lease is an attractive form of financing investments in economic, legal and organizational terms, especially for small and medium-sized enterprises. The impact of legislation on leases is significant as the law has influenced their specific shape. Organizational factors are understood as activities related to processing a transaction, and financial factors as the primary determinant of investment decisions (Wilczyńska, p. 166). The term of lease defines 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 (Zasiewska, p. 155). Lease assets may include tangible fixed assets, i.e. cars, computers, real properties; and intangible assets, i.e. licenses and patents. In a lease agreement, the parties are the lessor (providing an asset) and the lessee (paying for the use of an asset). Furthermore, lease agreements are divided into capital lease agreements (long-term investments) and operating lease agreements (exploitation, current leases). What is more, the legislation variously defines capital and operating leases, hence the records ought to be thoroughly examined in order to properly define and distinguish both types of lease agreements for purpose of the Accounting Act, as well as separately for tax purposes.

The essence of costs

Economic activity is inseparably linked with incurring costs. The costs which are associated with an economic activity shall be understood as a consumption of various production factors (tangible fixed assets, materials, manpower, external services) expressed as a value, concerning a specific unit of time and associated with obtaining desired results in the form of products. In a broader sense, "costs express a consumption of tangible fixed assets in the course of business activity within a certain period of time, external services and manpower, provided that the components show results in the forms of manufactured goods or services. The costs also include issues not related to the consumption of resources, apart from the existing legislation, e.g. taxes on costs, property insurance, social insurance, fees etc. The above are so called purely pecuniary expenditures" (Kiziukiewicz T., pp. 55-61). Defining costs is a complex process, and it is understood ambiguously. The Accounting Act (No. 3, item 31) defines costs and losses as "probable decreases of economic benefits of a reliably estimated value, which may arise during a reporting period, in the form of decreases in the value of assets or increases in the value of liabilities and provisions that will result in a decrease of the equity or an increase of the equity deficit in a manner other than through a withdrawal of funds by shareholders or owners" (the Accounting Act of 29 September 1994, consolidated text: Journal of Laws of 2013, item 330, as amended; Journal of Laws of 2014, item 768, item 1100; Journal of Laws of 2015, item 4). On the other hand, the Income Tax Act shows the concept of costs as an emphasis of their role in relation to revenues. According to the No. 15, item 1 of the Corporate Income Tax Act, „the deductible costs of individual sources are all costs incurred to generate revenue" (the Corporate Income Tax Act of 15 February 1992, consolidated text: Journal of Laws of 2011, No. 74, item. 397 as amended). According to the conceptual assumptions of the International Financial Reporting Standards, „costs arise due to operating economic activity of an entity. Such expenses include cost of sales, salary and depreciation. Usually, they take the form of either outgoings or decrease in the value of assets, such as cash and its equivalents, inventory and tangible fixed assets" (Conceptual Framework for Financial Reporting 2011, Chapter 4 & 4.33, p. 50). It should be emphasized that costs incurred in the enterprise are the primary factor shaping their financial results, and should contribute to achieving the long-term objective. What is more, the definition of cost must not be identified with expenditures or expenses, as these are synonymous.

Capital leases and operating leases

In Poland, lease agreement was accounted for an unnamed type of contract until the end of 2000. The term of unnamed means not regulated by law. Lease as a source of financing began to be applied in early 90s of the twentieth century, while the term of leasing agreement was formulated in 2000 by specification in the Civil Code. The terms of „lessee" and „lessor" have been adopted after the change of the Civil Code, since 9th of December 2000 (Journal of Laws, No. 74, item. 857). According to the Civil Code (No. 709), definition of lease includes an agreement for the lease of an asset that contains a provision giving the lessee an option to acquire title to the asset upon the fulfilment of agreed conditions, and to provide this asset to the lessee for use for the specified period of time. The lessee shall agree to pay a wage in agreed instalments, at least equal to the price or remuneration in respect of sale of this asset by the lessor.

Leases are regulated in the legislation by the following provisions:

- The Accounting Act - in terms of accounting records,
- The Civil Code - in terms of lease agreement,
- Legal Persons Income Tax Act, Individual Income Tax Act - in terms of income tax,
- VAT Act - for the purposes of VAT,
- International Accounting Standards 17 - types of leases,
- National Accounting Standards No. 5 - in terms of lease, rental and tenancy.

Lease is a specific agreement as it combines the features of rental agreement with loan agreement. It is some kind of form of lending, in which the investor receives assets without paying for them. Lease is an agreement under which the lessor provides the lessee the right to use tangible fixed assets for a certain period of time in return for payment. This is also a type of contract of lending by one party (the lessor) to another party (the lessee). It may be assumed that the essence of a lease agreement is to finance the purchase of durable goods, their temporary chargeable handover to the lessee without acquiring the ownership of an asset during the term of an agreement, with the possibility of transfer of the ownership after termination of that agreement. Moreover, it is accepted that lease period shall be at least 12 months (Walińska, p. 978). Lease is a form of financing the growth of enterprises by external sources.

Lease allows for (Kruczalak, pp. 16-21):

– stabilization of business environment and the ability to anticipate expenses of the company, which is provided by correlation between values, terms of payment of lease rates and expected benefits deriving from use of an asset;

– increasing the financial liquidity of economy businesses through use of external funds (company may spend its own funds for other purposes);

– lack of deterioration of creditworthiness of the company, since lease transactions are not included as liabilities in the balance sheet;

– no obligation to make advance payments preceding a deadline for receiving an asset;

– significant reduction of the risk of depreciation after use of assets by the possibility of easier exchange on an appropriate contractual clause.

Firstly, lease agreements are separated due to the character of liabilities between the contractual parties. There are two types of leases: capital leases and operating leases. Secondly, due to the number of entities involved in the transaction: it is necessary to distinguish direct lease - the producer (lessor) enters into agreement directly with the user (lessee); and indirect lease - there is a financing entity of the entire transaction, i.e. the lessor (http://cenabiznesu.pl/-leasing-podstawowe-zasady). When choosing a capital lease, the entrepreneur must know that the subject of lease shall be categorized to assets of the lessee. In contrast to operating lease, the lessee is obliged to calculate depreciation expenses. What is more, the beneficiary may include the interest component of lease instalment to the deductible costs. Value added tax must be paid in advance on the first instalment after receiving an asset. Furthermore, the client becomes the owner of leased asset immediately after payment of the last instalment. The subject of lease is considered as one of assets of the lessor, who is obliged to calculate depreciation expenses in case of the operating lease. Lease instalments are considered as deductible costs (including VAT and entry fee). The sum of payments specified in the agreement (decreased by VAT) shall comply with at least the initial value of fixed assets. The lessee has the right to purchase the subject of lease after termination of the agreement (http://cenabiznesu.pl/-leasing-operacyjny-a-leasing-finansowy-podstawowe-roznice). Table 1 shows the characteristics of leasing agreements, simultaneously summing up the issues related to operating and capital leases

Table 1. **Operating lease and capital lease - comparison**

Criterion	Capital lease	Operating lease
Depreciation	Obligation of the lessee	Obligation of the lessor
Duration of the agreement	Lack of legal restrictions in this field - in theory any period of time, although it is often similar to depreciation period (over 12 months)	Usually this period is shorter than period of tax depreciation for tax reasons (however, it is not shorter than 40% of so-called normative depreciation period of tangible fixed assets; or 10 years in case of real properties)
Purpose of the agreement	The use and purchase of tangible fixed asset	The use of tangible fixed asset
Deductible expenses	The lessee shall include the cost of interest component of lease payments and depreciation	The lessee shall include the net costs of instalments and the initial fee
Income tax	The lessee shall calculate depreciation expenses of the asset; deductible costs contain interest income of each lease instalment	The lessor shall calculate depreciation expenses of the asset; payments, preliminary fees and other expenses associated with use of the asset are deductible costs of the lessor
The Accounting Act	The subject of lease agreement is considered as tangible fixed asset of the lessee (however, the criteria for the division of operating and capital leases in this case are quite different from the criteria used for tax purposes)	Lack of legal restrictions in this field - in theory any period of time, although it is often similar to depreciation period
VAT tax	Lease is treated as a supply of goods with the first instalment, it is paid in advance. VAT is also charged in advance at the time of signing an agreement; VAT is deductible by the lessee (with certain restrictions)	VAT is added to the lease instalments, lease is treated as a service; VAT is charged on each instalment and is deductible by the lessee (with certain restrictions)
Redeemability	An asset becomes a property of the lessee with the last instalment	Dependent on the depreciation rate and the period of repurchase

Source: Study of the authors based on http://cenabiznesu.pl/-leasing-operacyjny-a-leasing-finansowy-podstawowe-roznice and http://www.leasing.org.pl/o_leasingu/krotka-historia-leasingu

Initial costs are the decisive factor for entrepreneurs when selecting a form of lease. Definitely, they are lower in case of operating leases due to lower engagement of the equity. Operating lease is also preferable when the estimated useful life of an asset is relatively short, as it is possible to increase the running costs of the enterprise, and thus reducing the tax base.

Records of capital leases and operating leases

Capital lease is an agreement according to which one party (referred to as "the lessor") grants the other party (referred to as "the lessee") the right to use tangible fixed assets in exchange for a fee, as well as the right to receive related rewards for a definite period of time, provided that the agreement meets at least one of the following conditions specified in the Accounting Act (No. 3, item 4):

1. The title of ownership to the asset is transferred to the lessee after termination of the agreement.
2. The lessee is provided with an option to purchase the asset after termination of the agreement for a price which is lower than the market price as at the purchase time.
3. The duration of the agreement ought to cover the major part of the expected economic useful life of the asset or property right, but may not be less than three quarters of that period.
4. The total lease payments, net of the related discount, which is determined as at the agreement date and due over the term of the agreement, exceed 90% of the market price of the leased asset at that time. Total lease payments shall include the residual value of the leased asset, which is paid in return for the transfer of title of ownership to the asset. They shall not include any payments to the lessee for additional services, taxes and insurance fees if they are incurred irrespective of the lease payments.
5. Commitment of the lessor shall be included to conclude a subsequent lease agreement, or to extend the existing agreement under more favourable conditions.
6. The option to terminate an agreement shall be provided. What is more, any related costs and losses incurred by the lessor are to be covered by the lessee.
7. The leased asset is tailored to the individual needs of the lessee. It may be used only by the lessee without making any significant modifications.

Records of capital leases of the lessee (Czubakowska K., p. 51):

1. Invoice received from the lessor:

Credit 240 Other settlements
Debit 300 Settlement of the purchase

2. Settled invoice:

a) an asset was seized at the agreed purchase price (excluding VAT): Credit 300 Settlement of the purchase, Debit 010 Tangible fixed assets in use

b) the sum of leasing interests was transferred (costs of lease): Credit 300 Settlement of the purchase, Debit 220 Other accruals

c) deductible input VAT was transferred: Credit 300 Settlement of the purchase, Debit 220 VAT Settlement;

3. Interest expenses for a given month were settled: Credit Other accruals, Debit 751 Financial expenses

4. Depreciation of tangible fixed asset in a given month: Credit 060 Depreciation allowance of tangible fixed assets, Debit 400 Depreciation

5. The liabilities (lease payments) to the lessor were regulated by bank transfer (instalment of repayment of the leased asset plus interests): Debit 240 Other settlements, Credit 130 Bank account

6. The subject of lease was included in off-balance sheet records: Debit 240 Leased tangible fixed assets (off-balance sheet account)

Records of operating leases of the lessee (Czubakowska K., p. 52):

1. The subject of lease was included in off-balance sheet records: Debit Leased tangible fixed assets (off-balance sheet account)

2. The invoice was received from the lessor for an entry fee and ongoing charges: Credit 240 Other settlements, Debit 300 Settlement of the purchase

3. The invoice was settled:

a) the instalment of lease payment charging operating expenses: Credit 300 Settlement of the purchase, Debit 420 External services

b) input VAT of lease transaction: Credit 300 Settlement of the purchase, Debit 220 VAT settlement

4. The liability to the lessor was regulated by bank transfer: Credit 130 Bank account, Debit 240 Other settlements

Records of capital leases of the lessor (Czubakowska K., p. 53):

1. Issuance of the subject of lease to the lessee at an agreed purchase price (record book).

2. The invoice was settled for the lessee: Credit 010 Tangible fixed assets in use, Debit 200 Settlements with the recipients

a) revenues liable to the settlement over time (leasing interests): Credit 842 Revenue accruals, Debit 200 Settlements with the recipients

b) input VAT from the lessee: Credit 220 VAT settlement, Debit 200 Settlements with the recipients

3. Part of interest revenues were settled for a given month: Debit 750 Financial revenues, Credit 842 Revenue accruals

4. The liability to the lessor was regulated by bank transfer: Credit 200 Settlements with the recipients, Debit 130 Bank account

5. The subject of lease was included in off-balance sheet records: Debit Leased tangible fixed assets (off-balance sheet account)

Records of operating leases of the lessor:

1. The invoice was settled for the lessee:

a) the instalment of lease payment comprising revenues of service sales: Credit 700 Sale of product, Debit 200 Settlements with the recipients

b) input VAT: Credit 220 VAT settlement, Debit 200 Settlements with the recipients

2. Depreciation of the asset of operating lease: Credit Depreciation allowance, Debit 400 Depreciation

3. The liability was regulated by bank transfer: Credit 200 Settlements with the recipients, Debit 130 Bank account

4. The subject of lease was included in off-balance sheet records: Debit Leased tangible fixed assets (off-balance sheet account)

An asset ought to be included in the account books of the lessor in case of operating leases. The lessor shall have control over the book and calculate depreciation expenses. The subject of lease is demonstrated as a fixed asset according to the nature of that object - either as tangible fixed asset or intangible asset. The lessee shall demonstrate an asset in off-balance sheets as external tangible fixed assets or external intangible assets; the financial statement shall be demonstrated in the additional information field.

Lease instalments, representing revenues for the current period in the account books, are liable to income tax. What is more, they are considered as deductible expenses from the point of view of the lessee. The lessee shall include its value only in the off-balance sheet after the signing of both agreement and approval to use the leased asset (Zasiewska K., pp. 159-160). When choosing a capital lease, the lessee takes control over the leased asset. Moreover, the lessee acquires the right to demonstrate it as a tangible fixed asset, simultaneously having the right to calculate depreciation expenses. The invoice issued by the lessor includes the input VAT in accordance with current regulations in addition to the agreed value of the asset and interests.

From the point of view of the lessee, costs that are directly attributable to the acquisition of leased asset should increase its initial value. If the lessee bears additional costs during the term of an agreement (e.g. insurance costs, operating costs of the leased asset), these costs should be treated in the same way as for tangible fixed assets or intangible assets. Furthermore, some of additional costs incurred by the lessor may be calculated as lease payments, and then these costs will be a part of initial value of the asset (Zasiewska K., pp. 162-163).

Conclusion

Lease is a way to obtain financial resources (investment objects), which are necessary to develop enterprises. What is more, lease is an attractive form of financing investments in economic, legal and organizational terms, especially for small and medium-sized enterprises.

In the initial period, lease agreement was regarded as a way to circumvent obligations arising from payment of taxes, and not as a form of financing that allows to gain tax benefits.

There are many sources of legislation concerning leases. These provisions are complementary, they also represent the essence and principles of this financial instrument. The Accounting Act also defines this form of financing for the purposes of the balance sheet. The Act also provides the possibility to use the National Accounting Standards (NAS) or the International Accounting Standards (IAS) in a situation where the certain issue is not specified by law. In this regard, entrepreneurs should be noted of detailed analysis of lease agreements and their general conditions concerning the fulfilment of specified conditions.

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