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Accounting Operating Lease- A Constructive Capitalization Strategy

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Introduction

A large number of business organisations started resorting lease finance as a major source for funding their projects which resulted in the accounting standards to responding promptly. IASB and FASB joined together in 2006 for a project for upgrading the accounting standards for lease transactions. As an outcome of that the Exposure Draft: Leases, wasissued in August 2010.. In the latest draft the above said boards suggested to bring the operating lease in the picture, more precisely into the balance sheet (Biondi, et al., 2011). As regarding the accounting, operating Lease was treated as an item in the revenue expenditure even though it has a significant say in continuing liability for both the parties in the lease contracts. Normally lease contracts run for more than one year. So the item has to be treated as a liability instead of being treated as just an expense (Nunung Nuryani et. al. 2015). Thus this paper has aimed to give additional evidence by using data from Indian listed companies of to support previous findings that shows the benefits of capitalisation of operating lease in decision making of investors.

The managers of the business organisations have the freedom in adopting the accounting method to be utilised in the company. But it should be in tune with the economy in which it functions. But in reality, the managers misuse it for maximising the profits for the company or to the insiders. Treating operating lease as an OBS item is one of such flexibility utilisations mentioned above. Selecting those kinds of accounting methods without considering the real financial state of the firm will lead to distorted, unfair and ambiguous financial reports. When the capitalisation of all leases is demanded by the accounting standard, it would decrease the risk of mishandling of operating lease strategy, thereby the financial statements, by those who are assigned to provide true figures to the public (Nunung Nuryani et. al. 2015).

According to the studies of Cornaggia and others (2012) and Lückerath and Bos (2009), this paper focusses on learning if the financial performance of a business organisation is influenced by capitalising the operating leases. Financial ratios are the common tools generally used by the stakeholders to assess the performance of business organisations. The changes in the financial ratios after incorporating the above said modifications be analysed by appropriate tools and if found significant, we can reach to the conclusion that the information regarding the operating lease to be reported in the books of accounts, is significant in the investment process by the people. The financial data of the some corporate giants listed in Indian stock exchanges were taken for this study. The study looks forward to provide more proofs to strengthen the previous studies, i.e. the arguments advocating to include all leasing into the balance sheets (Nunung Nuryani et. al. 2015).

Capitalisation of Operating Lease

The new accounting standards are very particular about companies to reveal the liabilities arising out of non-cancellable operating leases. Managers take unjustifiable benefits of operating lease scheme to conceal obligations in the position statements to make them more eye catching. They think that these assets when treated as financial lease can adversely influence financial position, firm will near to break the debt conventions, decrease the returns paid to the shareholders, also affect the debt-equity ratio. These all can be very unsafe for a company when it is all about retaining the existing investors as well as attract new people into it (Kieso et al., 2011).

The aforesaid facts tends the companies to move away capitalizing lease transaction and for opting operating lease. At the same time, there is no much difference these two methods can bring at the cash-flow aspect, i.e. both are making similar cash-flows. Therefore there is unending dispute on bringing lease commitments to the balance sheet (Nunung Nuryani, 2015). In India also the convergence of IFRS is being carried down on a phased manner. IFRS 16 deals with the lease transactions; the definition and accounting treatment, for instance. One of the major developments in the accounting treatments of lease contracts in in India is that the operating leases will be capitalised. The Indian accounting standard corresponding to IFRS will be IFRS 116. The new standard is to be implemented from the second quarter of 2019.

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Ind AS17 and IFRS16 synchronisation

Accounting standard norms for recording lease transactions both under conventional method and converged recent standard are compared and its snapshot is given below for quick grasp.

Table.1_A quick glance on the comparison between AS 19, Ind AS 17 and Ind AS 116/IFRS 16

	Basis	**AS 19**	**Ind AS 17**	**Ind AS 116 / IFRS 16**
1	Scope	Silent on land leasing. Silent on sub leasing.	Provisions are there for land leasing Silent on sub leasing.	Provisions are there for land leasing Covering the sub leasing aspects.
2	Definition	Agreement where the lessor transfers the right to use of an asset to lessee in return of a series of lease rentals.	Agreement where the lessor transfers the right to use of an asset to lessee in return of a series of lease rentals.	Agreement where the lessor transfers the right to control of an asset to lessee in return of a series of lease rentals for a period of time.
		Silent on the determination of such arrangement	Guidance on determining the lease arrangement is given	Guidance on determining the lease arrangement is given. .
3	Residual value	Anticipated value of the property under question once the lease contract is expired.	Silent on residual value	Silent on residual value
4	Sale and Leaseback of financial lease.	P/L emerged out of such transaction should be deferred and be amortised for the lease tenure on the proportion of the depreciation.	P/L should be amortised the lease tenure. The detailing regarding the proportion is not given.	P/L should be amortised the lease tenure. The detailing regarding the proportion is not given.
5	Initial direct cost- Operating Lease	Either defer the expense and allot to the revenue throughout the tenure or as an expense in the income statement.	Included in the carrying amount of the asset and recognised as an expense over the lease period.	Included in the carrying amount of the asset and recognised as an expense over the lease period.
6	Initial Direct	The initial direct	Initial direct costs are included in	Para 69 mentions that it is
	Cost – Finance	expenses: either	the initial measurement of the	included in the initial
	Leases	identified instantly	finance lease receivable and	measurement of the net
		in P&L or allotted against	reducing the amount of income	investment in the lease and
		the finance income over	recognised over the lease term. The	reduce the amount of
		the contract period.	interest rate implicit in the lease is	income recognised over the
			defined in such a way that the initial	lease term. The interest rate
			direct costs are included	implicit in the lease is
			automatically in the finance lease	defined in such a way that
			receivable; there is no need to add	the initial direct costs are
			them separately	included automatically in

				the net investment in the
				lease; there is no need to
				add them separately.
7	Incentives	Silent on lease incentives	Deducted against the rental revenue over the tenure.	Deducted from lease rentals.
8	Lessee's categorisation of lease	Categorised into OL FL	Categorised into OL and FL	No classification
9	Accounting and Presentation in financial Statement by lessee	Under Operating lease, asset was not recorded in books and recognized lease payments as expense in the profit and loss account.	Under Operating lease, assets was not recorded in books and recognized lease payments as expense in the profit and loss account	All leases with a tenure more than a year will be identified. Will recognise depreciation against right of use asset and the interest against the lease liability
10	Modification of terms	Silent regarding modification	Silent regarding modification	Provisions are given regarding lease modifications.
11	Disclosures for lessor.	Partially exempted for small companies.	No exemptions	Disclosure of maturity analysis of lease payments; adequate explanation of significant changes in carrying amount of new investment in finance lease.
12	Disclosures for lessee	NA	NA	Disclosure of maturity analysis of lease payments; adequate explanation of significant changes in carrying amount of new investment in finance leases.

Source: Vinod Kothari Consultants

Literature Review

Many a time the lessees use the lease arrangements to take advantage of avoiding the liabilities to be shown in the books of accounts. The main objective of such a practice is to make the balance sheet more attractive to the users or specifically, the investors, a manipulative practice which is quite common these days (Kieso, Weygandt, & Warfield, 2011). This practice can be attributed against to the principle of substance over form. This principle highlights the importance of the economic reality rather than the form which is allowed by the legal framework (Mukherjee & Hanif, 2003). The application of substance over form principle on assets is due to the fact that if the ownership is considered as the criteria for asset recognition, more and more assets will be kept outside the balance sheet. It is also applicable to liabilities and equities in a firm (Nuryani, Heng, & Juliesta, 2015).

Studies by Lückerath & de Bos, 2009) suggested capitalisation of operating lease heavily influenced the investors choice for their lasting interest. It needs all the related assets and debts to be stated in the balance sheet from the commencement of the contract itself. (Imhoff et al., 1991). The first study of this kind was undertaken by Nelson; a study focussing on the impacts on the financial ratios as a result of capitalisation of OL (1963, in Imhoff etal., 1991). The intention was to examine if the conversion would bring mor light to the ratio analysis. The result was affirmative.

Beattie et al. (1998) could understand that operating leases in the companies in USA impacted the financial ratios at a considerable level; they even proved it. It was not just a change in the figures. It affected the investors'choice of investment, management policy on the issue,

. it is also inferred that a meaningful and unbiased comparison was impossible unless operating lease was treated appropriately (Lückerath and Bos, 2009). finding supports previous studies (Imhoff et al., 1991; Beattie et al., 1998; Bennet & Bradburry, 2003) which evidently affirmed that capitalisation of OL influence ratio analysis.

Previous works in America (Imhoff et al., 1991), UK (Beattie et al., 1998), and New Zealand (Bennet & Bradburry, 2003) stated the capitalisation of OL has affected the financial ratios significantly. Capitalisation of operating lease will affect the decision taken by the investors provided, the financial ratios are considered to be a major ingredient for their decision making. This is the relevant information criterion in decision-usefulness as defined in International Accounting Standard Board (IASB, 2013).

From many significant studies from time to time, it is very evident that for accurate evaluation, capitalisation of OL is very important. It significantly disturbs profitability ratios, asset turn over ratios, liquidity ratios, solvency ratios etc.

Objective of the study

In this paper, the objective is to analyse the impact of constructive capitalisation of operating lease in the financial performance of the lessee companies.

As mentioned earlier, many studies are affirmative of the assumption that the change in the treatment of operating lease (capitalisation) has affected the financial statements and thereby affected the financial ratios. The investors use the financial ratio as a parameter for quality investment. So based on the aforementioned condition, the following hypothesis has been put forward.

H1: There are significant differences in financial ratios before and after capitalisation of operating lease.

Research Methodology

Data used in the study is obtained from Indian companies listed in Indian stock exchanges for the years from 2014 to 2017. Final sample of 10 companies has been taken from the industries that use the leasing as one of the major sources of funding fixed assets. The ratios under study is explained in Table.2. Table.3 shows the values of the different ratios of the lessee companies that are considered here for analysis.

Here the study aims to test the impact of operating lease on firms' financial ratios once it is taken to the balance sheet. The comparative model evaluates the change in the financial ratios before and after the constructive capitalisation of operating lease. If there were significant change, then it can be inferred that disclosure of information on operating lease is relevant because financial ratio analysis is used as one of the criteria by investors' for decision making. The hypothesis is tested by using paired sample t-test or Wilcoxon test on the basis of the normality of the data, i.e. for paired normal sample, t-test will be used. Otherwise Wilcoxon test will be used.

Financial ratios act as the benchmarks that help the investors to take quality decisions regarding the inclusion and exclusion of stocks and companies in their portfolio. Some of the major financial ratios that are used by the investors are Net Profit Ratio, Asset Turnover Ratio, Debt-Equity Ratio, Debt to Total Assets, Current Ratio, etc. These ratios assess the attributes like profitability, solvency, liquidity, etc. of a company. Table.2 shows the ratios considered for this study.

The ratios highlighted in Table.2 are used for evaluating the of the selected lessee companies. The performance is analysed before and after the capitalisation of the operating lease.

Table.2_Financial Ratios considered for the study

Financial ratios	**Before the change**	**After the change**
Net Profit Ratio (NPR)	Profit after tax / Total Sales	(Profit after tax + Change in Net Income) / Total Sales
Asset Turnover (AT)	Sales / Total Assets	Sales/ (Total Assets + PVA)
Debt to Equity Ratio (DER)	Total debt / Total share capital & Reserve	(Total debt +PVOL)/ (Total Share Capital and Reserve + change in Equity)
Debt to Total Assets (DAR)	Total debt / total asset	(Total debt + PVOL)/ Total assets +PVA

Current Ratio (CR)	Current Assets / Current Liabilities	Current Assets / Current Liabilities + PV (CF)

Source: Lückerath and de Bos (2009)

Table.3 shows the variations when the change was introduced to the financial statements.

Table.3_The financial ratios of the selected lessee companies before and after capitalisation.

		NPR		ATO		DER		CR		DAR	
Company	**Year**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**
Hindalco Industries Ltd.	**2014**	0.025	0.024	0.474	0.474	0.617	0.617	1.913	1.907	0.295	0.295
	2015	0.015	0.013	0.437	0.258	0.567	0.819	2.256	0.352	0.284	0.578
	2016	0.040	0.038	0.433	0.432	0.389	0.389	1.785	1.778	0.202	0.203
	2017	0.033	0.031	0.497	0.497	0.348	0.349	2.041	2.029	0.197	0.197
Indian Oil Corpn. Ltd.	**2014**	0.011	0.011	2.052	2.050	0.482	0.483	1.338	1.335	0.142	0.142
	2015	0.028	0.026	1.571	1.565	0.283	0.290	1.258	1.242	0.098	0.101
	2016	0.042	0.041	1.482	1.479	0.204	0.208	1.168	1.163	0.066	0.068
	2017	0.042	0.039	1.564	1.560	0.170	0.176	1.004	0.997	0.057	0.059
J S W Steel Ltd.	**2014**	0.043	0.042	0.651	0.650	1.024	1.024	0.969	0.967	0.329	0.329
	2015	-0.087	-0.088	0.493	0.493	1.459	1.459	0.622	0.621	0.361	0.362
	2016	0.063	0.062	0.635	0.635	1.163	1.163	0.701	0.700	0.312	0.312
	2017	0.070	0.069	0.703	0.703	1.059	1.059	0.797	0.796	0.313	0.313
Jet Airways (India) Ltd.	**2014**	-0.095	-0.095	0.951	0.951	-1.615	-1.615	0.369	0.369	0.328	0.328
	2015	0.053	0.053	1.066	1.066	-2.060	-2.060	0.427	0.427	0.301	0.301
	2016	0.070	0.064	1.324	1.316	-1.076	-1.107	0.481	0.477	0.434	0.438
	2017	-0.033	-0.038	1.461	1.453	-0.702	-0.723	0.520	0.517	0.320	0.323
Nuziveedu Seeds Ltd.	**2014**	0.132	0.129	1.101	1.096	0.065	0.078	1.024	1.018	0.017	0.021
	2015	0.116	0.112	1.018	1.015	0.041	0.052	1.198	1.191	0.012	0.016
	2016	0.109	0.105	0.893	0.890	0.019	0.026	1.264	1.257	0.007	0.010
	2017	0.109	0.105	0.893	0.890	0.019	0.026	1.264	1.258	0.007	0.009

Table.3 Cont. The financial ratios of the selected lessee companies before and after capitalisation

		NPR		ATO		DER		CR		DAR	
Company	**Year**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**	**PRE**	**POST**
Rashtriya Ispat Nigam Ltd.	**2014**	0.005	0.005	0.416	0.416	0.006	0.006	0.643	0.643	0.002	0.002
	2015	-0.130	-0.130	0.458	0.458	0.386	0.386	0.552	0.551	0.141	0.141
	2016	-0.099	-0.099	0.411	0.411	0.682	0.682	0.580	0.580	0.188	0.188
	2017	-0.082	-0.082	0.486	0.486	0.906	0.906	0.547	0.547	0.190	0.190
Reliance Industries Ltd.	**2014**	0.067	0.067	0.856	0.856	0.353	0.353	1.344	1.344	0.191	0.191
	2015	0.109	0.109	0.521	0.521	0.306	0.307	0.747	0.746	0.161	0.162
	2016	0.119	0.118	0.484	0.484	0.273	0.273	0.701	0.701	0.144	0.144
	2017	0.107	0.106	0.510	0.510	0.259	0.260	0.653	0.653	0.132	0.132
Reliance Infrastruc ture Ltd.	**2014**	0.130	0.130	-0.206	-0.206	0.403	0.403	1.504	1.504	-0.165	-0.165
	2015	-0.036	-0.043	0.165	0.165	0.760	0.761	1.120	1.116	0.237	0.237
	2016	0.052	0.048	0.153	0.153	0.519	0.520	1.209	1.207	0.179	0.180
	2017	0.138	0.134	0.145	0.144	0.395	0.395	1.125	1.124	0.140	0.140
Steel Authority Of India Ltd.	**2014**	0.040	0.040	0.500	0.500	0.322	0.323	0.900	0.900	0.138	0.138
	2015	-0.092	-0.094	0.408	0.407	0.446	0.447	0.684	0.683	0.164	0.164
	2016	-0.057	-0.059	0.431	0.431	0.530	0.531	0.611	0.610	0.166	0.167
	2017	-0.008	-0.010	0.473	0.473	0.834	0.834	0.738	0.737	0.240	0.241

Tata Steel Ltd.	**2014**	0.139	0.137	0.394	0.394	0.359	0.359	0.796	0.792	0.203	0.204
	2015	0.022	0.021	0.387	0.387	0.513	0.514	0.762	0.759	0.217	0.217
	2016	0.065	0.063	0.447	0.447	0.497	0.498	0.937	0.934	0.207	0.208
	2017	0.069	0.068	0.455	0.454	0.399	0.400	1.427	1.424	0.185	0.185

NPR-net profit Ratio, ATO-asset turnover, DER-debt equity ratio, CR-current ratio, DTA-debt to total assets, PRE- before capitalisation, POST-after capitalisation.

Results and Discussions.

The study aimed to test the EFFECT of capitalisation of OL on financial ratios. Normality test showed that Net Profit ratio and Debt to total Asset Ratio were normally distributed. Majority of the variables like Asset turnover, Debt equity ratio and Current ratio are not normally distributed (Table.4) and hence Wilcoxon test was used for analysis.

Table.4_Normality test results

	Kolmogorov-Smirnov[a]			
	Statistic	df	Sig.	Normality
NPR-PRE	.112	40	.200*	Normal
NPR_POST	.116	40	.186	Normal
ATO_PRE	.242	40	.000	Not normal
ATO_POST	.237	40	.000	Not normal
DER_PRE	.234	40	.000	Not normal
DER_POST	.232	40	.000	Nor normal
CR-PRE	.147	40	.029	Not normal
CR_POST	.144	40	.037	Not normal
DAR_PRE	.123	40	.128	Normal
DAR_POST	.116	40	.187	Normal

NPR-net profit Ratio, ATO-asset turnover, DER-debt equity ratio, CR-current ratio, DTA-debt to total assets, PRE- before capitalisation, POST-after capitalisation

The results of Wilcoxon test (Table.5) shows that capitalisation has brought significant changes in the financial ratio values in the two situations. It is very important to note that some negative changes were also found in the case of some ratios like Asset Turnover and Current ratios, debt to asset ratio, etc. These are in tune with intention of the off OBS financing where the companies make use of the operating lease method to conceal long term obligations off the balance sheet which adds colour in the picture of the position statement as well as performance statement of the company. This result underline the importance of taking operating leases into the balance sheet and also strengthen the previous studies on the topic.

Table.5_Wilcoxon test results

	Median-before	Median-after	Change	% of Change	Z values	Sig.
NPR	0.041905	0.04047	-0.00144	-3.42441236	-4.746	0.000
ATO	0.49483	0.49455	-0.00028	-0.05658509	-3.535	0.000
DER	0.38709	0.387545	0.000455	0.11754372	-2.83	0.005
CR	0.91866	0.84807	-0.07059	-7.68401803	-4.802	0.000
DAR	0.186055	0.186255	0.0002	0.1074951	-3.767	0.000

NPR-net profit Ratio, ATO-asset turnover, DER-debt equity ratio, CR-current ratio, DTA-debt to total assets, PRE- before capitalisation, POST-after capitalisation

Conclusion and suggestions.

The study finds that constructive capitalization has significant impact on the firm's financial ratios. It confirms capitalisation of OL is providing relevant information in the investors' decision making. That means, keeping the OL off the balance sheet will make financial statements biased, thus, misleads the users of the statements. It also indicates that comparability of companies are affected if the operating lease is not considered. It has to be clearly stated that it would be devastatingly unfair to the firms that don't use leasing finance for funding their assets. Comparability among business organizations and relevancy of financial ratios become at stake when operating lease is not capitalized.

Also the regulators have to stretch the scope of demanding companies to reveal their OL level in full.

Demanding firms to reveal other cost of borrowings and outstanding life of lease portfolio will increase the use of information on operating lease in decision making. Moreover voluntary disclosure of present value of lease obligation in the financial statements can lessen the accounting practices that hide debts and reduce bias that erode consistency of financial statements. Furthermore rules related to operating lease must be obligatory and supervised for compliance.

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