# Principles of fair market valuation of rights under leasing agreement with the option to purchase the property

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***ABSTRACT***--*The objectives of the study are aimed at improving of the tools for identifying and evaluating hidden assets of a company expressed in legal rights under leasing agreements with the property purchase option. Such rights can be identified as an asset, valued and will bring economic benefits to an economic entity. The methods of analysis, generalization, synthesis and comparison were used in the research.The article shows the basic principles of eligibility evaluation under the leasing agreement, explains their economic essence, describes the theoretical mechanism for the redistribution of assets between affiliates through the transfer of rights and obligations under leasing agreements.*

***Key words--leasing****, hidden asset, informal asset, affiliates, appraisal activities, financial analysis, management accounting.*

## I. INTRODUCTION

The tools for acquiring property for economic activity in the form of leasing are developed in world practice. According to the experts, the volume of leasing operations is growing in many countries, including Russia, European countries, the United States [7].

Leasing operations can take many forms, varieties and distinguishing features, leasing can be domestic (inside the country) and international, operational and financial, with or without the option to purchase the leased asset, taking into account the leased asset on the balance sheet of the lessor or lessee, etc. [8]. The development of leasing in the country contributes to the renewal of fixed assets of companies and, as a consequence, the development of production and the economy as a whole. The state stimulates the development of leasing at the legislative level [2]. Accelerated depreciation (for accounting and tax purposes) is provided at the legislative level as a tool to stimulate leasing, which allows to save the money (in a certain period) in the form of tax payments: profit tax is paid less (at the initial stage) from accrued and paid leasing payments the lessor reimburses VAT, in some cases, property tax is also saved. Another tool to stimulate leasing by the state is the compensation of a part of the lessee's expenses under leasing agreements at the expense of budget funds.

The accelerated depreciation, with a coefficient not exceeding 3 times the depreciation (compared to the standard depreciation, determined by the facility life) is provided in various regulatory documents [1,3,4]. Yes, the acquisition of fixed assets through leasing leads to an increase in the value of acquired property, but percentage terms on credit and borrowed funds (the acquisition of fixed assets from borrowed funds of specialized credit organizations) also leads to an increase in expenses.

## II. METHODS

During the research the terms of leasing agreements were analyzed and compared by the author. A comparative analysis of the contracts terms permitted to identify the possible mechanism for the formation of the hidden asset: the real financial position of the company in relation to the accounting reflection of the state of the financial situation.

As a rule, leasing agreements provide for the possibility of applying (by agreement of the parties to the leasing transaction) a mechanism for accelerated depreciation of the leased asset. This is beneficial to the lessor and lessee.

The occurrence of property of a hidden asset, which is not subject to reflection in the accounting and financial reporting registers, but can be determined, evaluated and taken into account in the valuation procedures for the company as a whole or for the rights arising from the leasing agreement with the lessee during the implementation of leasing relations with the right to purchase is considered in this research [14].

## III. RESULTS

If accelerated depreciation is applied by the time the leasing agreement expires, the lessee will be able to redeem the leased asset at a cost substantially less than the market value of the property (taking into account observed depreciation for the period of operation). Such an economic effect occurs in connection with an increased depreciation rate during the term of the contract.

As a result, (at the time of redeem of the leased asset) the actual financial status of the lessee (calculated on the basis of the market value of the object) will differ from the financial status reflected in the accounting:- the residual value of the item of fixed assets (determined by the rules of accounting) will be lower;- the value of undistributed profits will be less (or the value of uncovered loss will be more), respectively, the value of net assets will be less.

By the time the useful economic life of leased asset is completed, the financial situation will become more equable [5].

By means of a leasing agreement with the property purchase option, it is possible to redistribute assets between affiliates, it is possible to transfer a part of assets out of the organization in a crisis, pre-bankrupt state.

## IV. DISCUSSIONS

Let’s consider a theoretical model of the assets redistribution between business entities by the renewal of leasing agreement.

Let’s consider for this the example that illustrates this issue.

In fact, the companies A and B are affiliates, however, according to the available documents, this fact is difficult to elicit and prove.

The cost of the leased asset from the manufacturer (excluding percentage terms on leasing) is 1,000,000 monetary units (to simplify, all amounts are indicated without VAT, because VAT does not matter in this issue). The useful economic life of this property is 9 years, which also corresponds to the normal depreciation period (excluding accelerated depreciation).

The accelerated depreciation rate is 3, respectively, the accelerated depreciation period is 3 years.

The amount of additional payments (in addition to the value of the property (from the manufacturer)), taking into account insurance compensation and the percentage terms of the leasing company is 500,000 monetary units (MU).

The cost of the leased asset, taking into account all lease payments, is 1,500,000 MU

The total value of the lease payments under the leasing agreement over 3 years will amount to 1,500,000 MU including 1,400,000 MU are current lease payments and 100,000 MU - purchase payment at the end of the lease term. Leasing contract validity period is 3 years.

Aimed at equal recognition of the expenses, non-admission of underdeclaration of profit, and satisfying the accounting requirements, leasing payments, as it seems should be reflected in the following order.

Current lease payments (for redeemable property) are divided into two parts:- current expenses – current lease payments during the term of the leasing agreement are current expenses of the organization for accounting and tax purposes (in the considered example: 1,400,000 MU equally over 3 years);- the cost of capital investments, which after redeem from the leasing company, will form the initial cost (redemption value) of the item of fixed asset (in the considered example: 100,000 MU (under the terms of the contract: equally, throughout the contract validity period, but it can be paid on one occasion only at the end of the term).

Accordingly, the monthly lease payment (including recurrent expenses and part of the redemption value) will be 41,667 MU (1,500,000 MU / 3 years / 12 months).

Monthly lease payment in the amount of MU 41,667 is calculated by:- current expenses per month will be MU 38,889 (1 400 000 MU / 3 years / 12 months);- the formation (monthly payment) of the initial cost of the fixed asset per month will be MU 2,778 (MU100,000 / 3 years / 12 months).Suppose that 6 months before the completion of the lease agreement (the lease agreement is currently valid for 2.5 years (30 months)), upon a mutual agreement of the parties company A transfers (without any payment from company B to company A) all its rights and obligations under the lease agreement of company B. As an option (as agreed with the leasing company), this re-registration process occurs as follows: company A refuses the implementation of an agreement, the agreement is dissolved. And as soon as possible (without changing the remaining schedule and the sums payable), the leasing company concludes a leasing agreement with company B. It should be noted that concluding a leasing agreement under such conditions is economically advantageous (in comparison with the conditions in force on the open market). This is due to the fact that Company A, at the time of the renewal of the leasing agreement, incurred most of the costs of paying for the value of the property, however, the parties agree to this (as agreed). The leasing company does not lose anything and does not win, in fact, there is only a change of party under the deal for it.

By the end of the 30-month validity period of the leasing agreement, the amount of outstanding payments under the leasing agreement will be 41,667 MU/ month * 6 months = 250,000MU

As already mentioned, in order to determine the hidden asset in the form of economic benefits under a leasing agreement, it is necessary to determine the amount of the value of the fixed assets allowing for wear and tear, i.e.

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the market value of the leased asset at the time of renewal of the lease agreement (dissolving the agreement with company A and conclusion of the contract with company B). When determining the fair value of property, fluctuations associated with changes in the market situation of the respective fixed assets are not taken into account, and inflationary fluctuations are not taken into account in this analysis either. Fair (market) value is determined on the basis of the initial transaction price with the producer (1,000,000MU), the technically determined lifetime (9 years) and the actual lifetime (depreciation) of the property (2.5 years). the market value of the property in 2.5 years from the start of the lease agreement will be 833 333 MU (1,000,000 MU / 9 years * 7.5 years (remaining lifetime (economic life) of property))

Thus, upon renewal of the lease agreement, organization B will receive property valued at 833,333MU, and the amount of obligations under the lease agreement, company B will incur in the amount of 250,000MU. (in this example (to simplify) revaluation of lease payments in case of early buyout was not carried out).

The above example shows that when renewal of the leasing agreement for itself the company B actually receives the hidden asset, expressed in conclusion of a leasing agreement on favorable (not inherent in the open market) conditions in the amount of 583,333MU. It should be noted that the calculable value will be the greater, the more time has passed from the commencement of the lease agreement, the corresponding difference will be minimal at the initial stage, and the determined value will have a maximum by the date the lease agreement expires. The corresponding hidden asset in the form of rights under a leasing agreement at a certain moment of time will have a market value.

Speaking about fair market valuation of rights under a leasing agreement with the option to purchase the property, the author determined the following results.

The difference between the value of the property at the valuation date (taking into account actual depreciation) and all payments for the buyout of leased property (taking into account the revaluation of the cost of leasing payments in case of early buyout of the property) will be the result of a determined fair market valuation of the rights under a leasing agreement with the option to purchase the property. The practice of rental rights eligibility evaluation exists in valuation activities [13].

If the difference obtained is positive, then the result will be hidden assets of the company, which will bring economic benefits in the short term. Such a hidden asset is not subject to accounting under the existing accounting rules, but it is an informal asset that should be taken into account in the evaluation procedure (when evaluating the company as a whole or when determining the value of claims under a specific leasing agreement with the option to purchase the property).

If the difference obtained is negative the organization will have a dormant commitment that negatively affects the value of the company as a whole. However, it should be noted that according to the existing principles and the usual (often applied) rules of leasing agreements, the lessee can return the leased asset (property) and the obligations under the lease agreement will be repaid. The author believes that under normal conditions, this situation is unlikely, since the leasing company builds a schedule for paying off the leasing so that the lessee (taking into account advance payments under the lease agreement) pays a part of the value of the property upon obtainment of the property, and current payments compensate for the decrease in the value of the leased asset, pay percentage terms on a credit resource, cover property insurance, and also provide the rate of profit for a leasing company. As a rule, at any time (in the absence of emergencies and sharp fall in prices of the leased asset), the market value of the leased property will exceed the amount of obligations for all payments under the lease agreement.

Accelerated depreciation of property acquired on lease forms a hidden asset for the organization (in this case, the economic benefit occurring from alleviation of taxes or transfer of tax payments to future periods is not considered): the relevant accounting procedures underestimate the residual cost of the property and the amount of equity capital, which leads to hidden assets.

Fair market valuation of rights under the leasing agreement with the option to purchase the property may be appropriate when evaluating a business as a single asset complex. An assessment of the market value can be justified and appropriate in the event of the presumptive dissolving of the lease agreement: the management (and the owner) of the lessee must understand the economic consequences of early dissolving of the agreement.
A similar assessment of the value of rights under the contract is also necessary for fiscal authorities when revealing facts of redistribution of assets between affiliates (in case of dissolving of the leasing agreement with one company and conclusion of a leasing agreement on the same terms).

When using this valuation principle, it is necessary to take into account the presumptive adjustment for calculating leasing expenses in case of early buyout of the property. As a rule, leasing agreements stipulate that in case of early dissolving of a leasing agreement by early paying off all remaining leasing payments, the amount of leasing payments is subject to revaluation. This is due to the fact that money has a different value over time.
In valuation procedures, the value of property is determined at the relevant current date. Accordingly, the obligations under the leasing agreement must be reduced by calculation to the current date. This is done either taking into account the terms of the leasing agreement or through mathematical tooling used in valuation activities (reducing of the future payments (on schedule) to current value).

Such an eligibility evaluation will also be relevant when deciding to challenge of the transaction during the bankruptcy procedure: by such a renewal of the agreement, liquid assets (an option to purchase it under the leasing agreement) can be redistributed from the crisis company (pre-bankruptcy state) to a financially stable company.

To obtain clear calculations, documents that can be used in a lawsuit, it is advisable to involve a professional independent valuator. Valuation services are in demand in modern economic conditions. Evaluation of economic benefits that do not have direct tangible embodiment is not as developed as an evaluation of rights in rem, but still has a significant impact on the results of company valuation [11].

But for the purposes of managerial accounting, making a managerial decision, a competent manager or analyst, using the above principle, will be able to determine independently the hidden asset, expressed in excess of the property value over the amount of obligations for its purchase.

As a rule, under the terms of the leasing agreement, in case of dissolution of the leasing agreement at the initiative of the lessee or in the case of violation of payment terms by the lessee, the lease agreement is terminated, the leased asset is returned to the lessee without any compensation to the lessee, regardless of the size of the purchased share of the property. In this case, the accumulated hidden asset is not determined, the principles of which are described in this research.

The presence of such free contractual relations allows to carry out certain targeted actions that allow to redistribute the assets and liabilities between business entities, the organization can obtain (within certain limits) the necessary indicators of its activity [12, 15].

As already mentioned, such hidden assets are not subject to accounting, valuation and reflection in accounting. However, from the evaluative and financial point of view, such assets must be determined and accounted for. The possibility, necessity and expediency of valuation of rights under leasing agreements is provided for in the regulatory document governing the application of the system of national accounts (SNA) in Russia [6].

This document sets out the principles for assessment of the market value of assets such as contracts, leasing agreement, which are defined as an asset with simultaneous observance of two terms:- the terms of the leasing agreement determine the price for the use of the asset or for the provision of a service that differs from the price that would prevail in the absence of this agreement;-one of the parties to the transaction has the ability to implement legally and practically this price difference.

In the described mechanism for the occurrence of a hidden asset in the form of a leasing agreement with the option to purchase the property, both of these conditions are realizable.

Accordingly, the legislator makes it possible (for certain purposes) to determine the rights arising from the contract (including the leasing agreement) as an asset and to perform the valuation of these rights.

When determining the valuation of rights under a contract, a comparison of the fundamental term conditions over the relevant conditions inherent in the open market [6].

## V. CONCLUSION

It should be noted that a hidden asset occurring during the implementation of leasing relations under a leasing agreement can bring economic benefits to the company.

The presence of a difference in the value of the leased asset and the amount of obligations under the lease agreement (taking into account the revaluation of the size of these obligations in case of early repayment) can not always bring real income, an inflow of additional funds.

This may be a number of reasons, for example, the lessee is not able to provide current payments under the leasing agreement with his activity, i.e. the lessee is in a crisis financial situation, has signs of bankruptcy, etc. In such a situation (presence of signs of bankruptcy in the lessor), the risk (in the forecast bankruptcy procedure) of challenging of the debtor's transactions increases substantially, i.e. financial risks for counterparties increase [9]. Attracting of credit resources from the credit organizations for a company in a crisis situation (to purchase the leased asset for the purpose of further sale) is also difficult. Such factors can affect adversely the lessee's actions, limiting the possibility of obtaining the expected economic benefits from a hidden asset.

When evaluating the analyzed hidden asset in the form of rights under a leasing agreement, it is also necessary to take into account the liquidity of the leased asset. If that entails the highly liquid assets, the sale of which can be carried out in a short time, then all the principles described above will be fair in determining and valuation of the hidden asset. The results of property valuation can be different at various stages of the company's activities[10]. If that entails the low-liquid property, for example: special equipment, specialized production lines, then in this case it is advisable to use not the market but the liquidation value of the property, i.e. short-term value for the sale of this property.

Summing up, the author draws attention to the fact that when carrying out the valuation procedures (in relation to the company as a whole) it is advisable to analyze carefully, scrupulously and professionally all the elements of

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the company's assets, including those not reflected in accounting, it is necessary to find all hidden assets and economic benefits, relying to a greater extent not on the formal attributes of an asset, but on the principle of priority of the content over the form. This will allow to valuate the property more clearly, accurately and correctly, to conduct a financial analysis and make the right management decision.

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