

# LEASE FINANCING: A NEW DUAL APPROACH

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## Abstract:

*Leasing is an important additional financing technique used by many companies, enabling them to use property, plant and equipment without making large initial cash outlays. It also provides flexibility, allowing entities to address obsolescence risks. Under current accounting rules, when referring to the operating leasing in particular, there is a lack of comparability between the financial position and operating results of companies that buy assets and the financial position and operating results of those that lease similar assets. This has led critics to assert that the current accounting does not portray the economics of lease arrangements. In response to this criticism, the IASB and FASB have developed a new approach to lease accounting that would require a lessee to recognise assets and liabilities for the rights and obligations created by leases, this providing greater transparency and comparability for financial statements users. On the other hand, the proposals will affect almost every company and the impact of the proposed changes may be significant, as recognising additional assets and liabilities and finance expense will affect key performance ratios and, consequently, the ability to satisfy debt covenants.*

*This article reviews the basics of the dual-model approach, emphasising the key concepts that would be used by both lessees and lessors to identify, classify, recognise and measure lease contracts.*

**Key words:** *lease accounting, identifying a lease, lease classification, recognition and measurement of Type A leases, recognition and measurement of Type B leases*

**JEL classification:** M41

## 1. Introduction

Leasing is a widely used financing solution, enabling companies to use property, plant and equipment without incurring large cash outflows at the start. It also enables lessees to address the risks related to obsolescence and residual value (PWC, 2013c, pp. 3). Leasing arrangements satisfy a wide variety of business needs, from short-term asset use to long-term asset financing. In many cases, leasing is the only option available to obtain the use of a physical asset when it is not available for purchase because of the lack of financing resources (PWC, 2013a, pp. 1). Additionally, leasing offers many benefits like as: taxes, because companies can deduct the leasing expenses; management, through careful planning money accessibility and speed compared with bank financing (Ciorasteanu et al., 2011).

Being amounted to almost \$800 billion in 2011, according to “The 2013 World Leasing Yearbook”, the conclusion is that leasing is an important activity for many entities worldwide (IASB, 2013d, pp. 2). This means that it is important that users of financial statements have a complete and understandable picture of an entity’s leasing activities. The existing accounting models for leases require entities to classify their leases as either finance leases or operating leases and account for those leases differently. The International Accounting Standards Board (IASB) argues that those models have been criticised for failing to meet the needs of users of financial statements (ED/2013/6, pp. 5) because they do not always provide a faithful representation of leasing transactions [1].

Currently, IAS 17 *Leases* is focused on identifying when a lease is economically similar to purchasing the asset being leased (that is the ‘underlying asset’). When a lease is determined to be economically similar to purchasing this asset, the lease is classified as a finance lease and reported on the lessee’s statement of financial position. All other leases are classified as operating leases. Although commitments arise from operating leases as they do from finance leases, there is no obligation to be reported on the lessee’s statement of financial position. Consequently, the lessee’s financial statements provide a misleading picture about leverage and the assets that the lessee uses in its operations (IASB, 2013d, pp. 2).

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In order to address the concerns about the lack of transparency of information about lease obligations, in 2006 the IASB and the US Financial Accounting Standards Board (FASB) initiated a joint project to improve the financial reporting of leasing activities.

The project has developed a new approach to lease accounting, whose result would be that most assets and liabilities arising from lease contracts will be recognised in an entity's statement of financial position. An exposure draft was issued in August 2010 [2] setting out an accounting approach based on the premise that, in a lease contract, the lessee obtains the right to use an asset for a specified period, this resulting in a right-of-use (ROU) asset.

In May 2013, the IASB and FASB issued the revised joint exposure draft on proposed changes to the accounting for leases [3] that, if finalized as proposed, would change in a significant manner how entities account for and report leasing arrangements in their financial statements. The *core principle* of this draft is that an entity should recognise assets and liabilities arising from a lease (ED/2013/6, par. 1) and its *objective* is to establish the principles that lessees and lessors should apply to report useful information to users of financial statements about the amount, timing and uncertainty of cash flows arising from a lease (ED/2013/6, par. 3). These principles should be applied in order to identify, classify, recognise and measure lease contracts.

## **2. Identifying a lease**

According to the 2013 ED, a lease is defined as a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. The 'right-of-use' concept is intended to align with the control concept in the IASB revenue recognition project [4] (Holt, 2013).

For identifying a lease, entities need to determine whether:

- fulfilment of the contract, or an element of the contract, depends on the use of an identified asset or assets; and
- the contract conveys to the lessee the right to control the use of the identified asset(s) for a period of time in exchange for consideration (KPMG, 2013a, pp. 2).

The requirement for the arrangement to cover a specified asset is an important distinction (BDO, 2013, pp. 6), as it means that it would be necessary to be able specifically to identify the asset (for example, an item of plant and machinery or a building or a physically distinct portion of a larger asset).

A right to control the use of an asset is conveyed if the lessee has the ability to direct the use, and receive the benefit from that use throughout the lease term. The lessee's ability to direct the use of an identified asset would be demonstrated by its ability to make the decisions about the use of the asset that most significantly affect the economic benefits to be derived from the asset's use over the term of the contract. Such decisions may include how and for what purpose the asset will be employed during the contract term, how it is operated or who operates it.

We point out that, under current IFRS (IFRIC 4 *Determining whether an arrangement constitutes a lease*), the criteria used for identifying a leasing is not identical, referring to the *right to use*, not to the *right to control the use* of the specific asset. The change in emphasis envisaged may require a greater degree of judgement to be exercised when determining whether an arrangement is a lease (Deloitte, 2013, pp. 2).

## **3. Classification of Leases**

The underlying economics of leases vary and these differences are best reflected by two types of leases.

The principle for differentiating between the two lease types would be based on the portion of the economic benefits of the underlying asset expected to be consumed by the

lessee over the lease term. To reduce complexity in the application of this principle, entities would be required to classify leases primarily based on the nature of the underlying asset.

Under the proposal, leases would be classified at the lease commencement date as follows:

- leases of assets that are not property (e.g., plant, equipment, vehicles) would be classified as **Type A leases**, unless one of the following two criteria is met:

- (a) the lease term is for an insignificant part of the total economic life of the underlying asset, and
- (b) the present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date;

- leases of property (e.g., land and/or building or part of a building) would be classified as **Type B leases**, unless one of the following two criteria is met:

- (a) the lease term is for the major part of the remaining economic life of the underlying asset, and
- (b) the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A.

In the Basis for Conclusions on 2013 ED, the IASB notes that most leases of property would be classified as Type B leases and most leases of assets other than property would be classified as Type A leases. That is, the exception criteria noted above would be met for a relatively small population of leases (BC51-BC52).

As it can be seen, the distinction between the two types of lease under the 2013 ED is different from the current finance vs. operating lease distinction.

Still, the ED does not provide quantitative thresholds on what constitutes an ‘insignificant part’ of the total economic life or an ‘insignificant’ amount of the fair value of the underlying asset when performing the classification test for assets other than property, nor quantitative thresholds on what constitutes a ‘major part’ of the remaining economic life or ‘substantially all’ of the fair value of the underlying asset when performing the classification test for property assets (KPMG, 2013b, pp. 12-13).

Comparing the lease term of leases of non-property assets to the ‘total’ economic life of the underlying asset (as opposed to the ‘remaining’ economic life) may result in leases of certain older non-property assets being classified as Type B leases (Ernst & Young, 2013a, pp. 15). For example, many existing aircraft leases are expected to be classified as Type A under the proposals. But a three-year lease of an aircraft would likely be insignificant to the total economic life of the asset; therefore, regardless of the age of the aircraft at the commencement date of the lease arrangement, such a lease would be classified as Type B.

We conclude that evaluating whether a non-property lease meets either of the criteria for the exception would likely be subjective and require careful judgement.

Performing the lease classification tests may be very complex, as the lessees and lessors would need to determine the following items:

- *lease term* - the non-cancellable period of the lease, together with the period(s) covered by an option to extend or not to terminate the lease (referred to as the ‘lease term option’) if the lessee has a significant economic incentive to exercise that option;

- *lease payments* - payments during the lease term;

- *discount rate* - reflects the nature of the transaction and the terms and conditions of the lease (e.g., the lease term, the security attached to the lease, the nature of the underlying asset and the economic environment);

- *economic life of the underlying asset* - either the period over which the asset is expected to be economically usable or the number of production or similar units expected to be obtained from the asset; and

- *fair value of the underlying asset* using the fair value measurement guidance in current IFRSs.

Having determined the above items, lessees and lessors would determine whether the lease includes a purchase option that the lessee has a significant economic incentive to exercise. If so, the lease would be classified as a Type A lease. If not, lessees and lessors would apply the lease classification tests based on the nature of the underlying asset (that is property or not property).

#### **4. Lessee accounting**

The core principle of the proposed project of lease accounting has been that lease contracts give rise to assets and liabilities that must be recognized in the statement of financial position of both lessees and lessors.

Lessees would be required to recognise all leases, except short-term leases, in the statement of financial position. At the commencement date of the lease, lessees would recognise a liability to make lease payments (the lease liability) and an asset representing the right to use the underlying asset during the lease period (the ROU asset). The initial recognition of the ROU asset and the lease liability would be the same for Type A and Type B leases, as would the subsequent measurement of the lease liability; subsequent measurement of the ROU asset for Type A and Type B leases would differ.

##### **4.1. Initial recognition and measurement**

The lease liability would initially be measured based on the present value of the lease payments to be made over the lease term. The present value of the lease payments are discounted using the rate the lessor charges the lessee. If that rate could not be readily determined, the lessee would use its own incremental borrowing rate. The rate that a lessor charges the lessee is a rate that takes into account the nature of the transaction as well as the terms and conditions of the lease. Generally, this is the implicit rate in the lease.

The ROU asset would initially be measured at cost, based on the measurement of the lease liability. The ROU equals the amount of the liability to make lease payments, plus lease prepayments (less any lease incentives received from the lessor) and the lessee's initial direct costs.

The ED does not specifically state if the ROU asset is a tangible or intangible asset. Although the ROU asset seems to meet the definition of an intangible asset, the ED proposes that a lessee be permitted to apply a revaluation model if it meets the conditions to apply the revaluation model to property, plant and equipment (KPMG, 2013b, pp. 28).

##### **4.2. Subsequent measurement**

The subsequent measurement would depend on the nature of the underlying asset; therefore there are differences between the two types of leases. For both Type A and Type B leases, the lessee would subsequently measure the liability to make lease payments at *amortised cost* using *the effective interest method*. Lease payments would reduce the lease liability when paid.

The subsequently measurement of the ROU asset should be in accordance with one of three below methods:

- amortised cost (subject to impairment);
- in accordance with the fair value model in IAS 40 *Investment Property* if the underlying asset meets the definition of investment property and the lessee applies the fair value model as an accounting policy; or
- the revaluation model in IAS 16 *Property, Plant and Equipment* if all assets within the class of the leased asset are revalue.

The difference between the Type A and Type B leases is the way in which the right-of-use asset would be measured after initial recognition, and the associated effect on the income statement (BDO, 2013, pp. 14). Type A and Type B leases would achieve different expense recognition patterns through the subsequent measurement of the right-of-use asset.

\* **For Type A leases**, the ROU asset would be amortised on the same basis that the lessee would apply to the underlying asset, which is the way that reflects the pattern of consumption of the expected future economic benefits of the right-of-use asset.

The lease liability would be accounted for using the effective interest method (that is, in the same way as a conventional loan). Interest and amortisation expenses would be recognised separately in the income statement.

The total periodic expense (i.e., the sum of interest and amortisation expense) of a Type A lease would generally be higher in the early periods and lower in the later periods. Because a consistent interest rate would be applied to the lease liability, which decreases as cash payments are made during the lease term, more interest expense would be incurred in the early periods and less would be incurred in the later periods. This trend in the interest expense, combined with the straight-line amortisation of the ROU asset, would result in the recognition of more total periodic expense in the early periods of a Type A lease than a Type B lease (Ernst & Young, 2013a, pp. 19). This ‘front loading’ would be increased if the ROU asset is amortised on a reducing balance basis.

In addition, the amortisation expense will be included within operating results and the interest expense will be included within finance expenses. Consequently, the finance element will be eliminated from operating results. Entities will need to take into consideration the effect on their reported results, and the associated effect on key metrics that they report to the markets and other users of their financial statements (BDO, 2013, pp. 14).

\* **For Type B leases**, the lessee would calculate a periodic lease expense amount in a manner that is in some ways similar to today’s accounting for operating leases. Throughout the lease term, the lessee would recognise periodic lease expense as the greater of:

- the remaining cost of the lease (calculated at the beginning of each period) allocated over the remaining lease term on a straight-line basis, or
- the periodic interest expense taken on the lease liability (using the effective interest method).

The amortisation of the ROU asset would be measured each period as a balancing figure such that the total lease expense would be recognised on a straight-line basis, regardless of the timing of lease. In contrast to the Type A lease, the two components of the lease expense would be recognised as one single amount to be charged to operating results in the income statement.

#### **Example 1 – Lessee accounting for Type A and Type B leases with equal lease payments in each period**

A lease contains the following key terms: lease term is 6 years and the annual payments of CU1,000 are made at the end of each year. Lessee incremental borrowing rate (assuming the rate the lessor charges cannot be readily determined) is 5%.

Table no. 1 presents the effects on the lessee’s statements of financial position and comprehensive income.

**Table no. 1. Type A and Type B leases: effects on the lessee's statements  
of financial position and comprehensive income** - CU -

Periods	Years							Total expenses
	0	1	2	3	4	5	6	
TYPE A LEASE								
Statement of financial position								
ROU asset	5,076	4,230 <sup>(5)</sup>	3,384	2,538	1,692	846	-	
Lease liability	5,076 <sup>(1)</sup>	4,330 <sup>(4)</sup>	3,546	2,723	1,859	952	-	
Income statement								
Interest expense <sup>(2)</sup>		254	216	177	136	93	48	
Amortisation expense <sup>(3)</sup>		846	846	846	846	846	846	5,076
Total lease expenses		1,100	1,062	1,023	982	939	894	6,000
TYPE B LEASE								
Statement of financial position								
ROU asset	5,076	4,330	3,546	2,723	1,859	952	-	
Lease liability	5,076 <sup>(1)</sup>	4,330 <sup>(4)</sup>	3,546	2,723	1,859	952	-	
Income statement								
Total lease expenses		1,000 <sup>(6)</sup>	1,000	1,000	1,000	1,000	1,000	6,000

<sup>(1)</sup> Present value of the lease payments of CU1,000 discounted by the incremental borrowing rate of 5%.

<sup>(2)</sup> Present value of the lease liability at the beginning of each year multiplied by the incremental interest rate of 5%; e.g., for Year 1: CU5,076 × 5% = CU254.

<sup>(3)</sup> For Type A leases, the ROU asset's amortisation expense is calculated by dividing the ROU asset carrying amount on commencement of the lease CU5,076 by the lease term of 6 years, that is CU846.

<sup>(4)</sup> Present value of the lease liability at the beginning of the period less the 'principal' part of each lease payment; e.g., for Year 1: CU5,076 - (CU1,000 - CU254) = CU4,330.

<sup>(5)</sup> CU5,076 - CU846 = CU4,230.

<sup>(6)</sup> Accretion of interest on the liability of CU254 plus amortisation of the ROU asset at a 'balancing figure' amount of CU746 (which is also used as the 'principal' part of the lease payment) to give a total charge of CU1,000.

**Table no. 2. Type A and Type B leases: journal entries recorded by the lessee**

Journal Entries			
Type A leases:		Type B leases:	
(a) At lease commencement Entity A recognises the lease-related asset and liability:			
Right-of-use asset	CU5,076	Right-of-use asset	CU5,076
Lease liability	CU5,076	Lease liability	CU5,076
To initially recognise the lease-related asset and liability			
(b) The following journal entries would be recorded in Year 1:			
Interest expense	CU254	Lease expense	CU1,000
Lease liability	CU254	Lease liability	CU254
To record interest expense and accrete the lease liability using the effective interest method		Right-of-use asset CU746	
Amortisation expense CU846		To record lease expense, accrete the lease liability and adjust the right-of-use asset (change in right-of-use asset = CU1,000 annual straight-line lease expense less CU254 accretion of liability using effective interest method)	
Right-of-use asset CU846			
To record amortisation expense on the right-of-use asset			
Lease liability	CU1,000	Lease liability	CU1,000
Cash	CU1,000	Cash	CU1,000
To record lease payment			

## 5. Lessor accounting

Lessors would account for Type A leases using a complex new accounting model. Type B leases would be accounted for using a method similar to current operating lease accounting.

## 5.1. Type A leases

### \* Initial recognition and measurement

Upon commencement of a Type A lease, lessors would derecognise the carrying amount of the underlying asset and allocate that amount between the portion related to the right to use granted to the lessee and the portion that is retained (i.e., the residual asset). A lease receivable for the right to receive lease payments during the lease term would also be recognised. The profit related to the right of use granted to the lessee would be recognised in profit or loss at lease commencement.

The lease receivable would be measured as the present value of the lease payments to be received during the lease term. Additionally, residual value guarantees would generally be excluded from the lease receivable.

The carrying amount of the derecognised underlying asset would be allocated between the portion leased and the newly recognised residual asset. The ED describes the initial measurement of the residual asset as:

$$A + B - C \quad (1),$$

where:

- A is the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (gross residual asset);
- B is the present value of variable lease payments, which the lessor expects to receive and which have been reflected in the rate the lessor charges the lessee, but which are not included in the lease receivable (e.g., variable lease payments linked to performance);
- C is any unearned profit.

The portion leased would be calculated as the ratio of the present value of the lease payments to the fair value of the underlying asset, multiplied by the carrying amount of the underlying asset immediately before lease commencement. Consequently, the initially recognised residual asset also could be initially calculated as follows:

$$\text{Carrying amount of underlying asset} - \frac{\text{Carrying amount of underlying asset}}{\text{Fair value of underlying asset}} \times \text{Present value of lease payments} \quad (2)$$

The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term would be referred to as the gross residual asset. The gross residual asset would not be recognised in the statement of financial position. The difference between the gross residual asset and the recognised residual asset would be the aggregate of the unearned profit and the present value of any variable payments included in the initial measurement of the residual asset. The recognised residual asset would be subsequently accreted.

A lessor would have a profit if the fair value of the underlying asset is greater than its carrying amount immediately before commencement of the lease. Of this total profit, the amount recognised at lease commencement is as follows:

$$\text{Profit recognised at lease commencement} = \text{Total profit} \times \frac{\text{Present value of lease payments}}{\text{Fair value of underlying asset}} \quad (3)$$

### \* Subsequent measurement

After lease commencement, lessors would:

- recognise interest income on the accretion of the lease receivable using the effective interest method at the interest rate that would produce a constant periodic discount rate on the remaining balance of the receivable;
- reduce the lease receivable for lease payments received;
- recognise interest income on the accretion of the gross residual asset using the rate the lessor charges the lessee;
- recognise income from variable lease payments that are not included in the lease receivable in the period in which that income is earned and derecognise the portion of the residual asset associated with the variable lease payments.

### **Example 2 – Lessor accounting for Type A leases**

Lessor A enters into a non-cancellable lease contract with a lessee under which leases an equipment for 6 years. The total economic life of the equipment is estimated to be 10 years. The annual lease payments, which are due at the end of each year, are CU1,000 and lessor's discount rate is 5%. The present value of the right to receive lease payments is CU5,076 (as in Example 1).

The estimated future value of the asset at the end of Year 6 is CU1,500, which is discounted at the rate that the lessor charges the lessee (5%) to give a gross residual asset of CU1,119.

The fair value of the equipment is CU6,195 and at the commencement of the lease the equipment has a carrying amount of CU5,500. Consequently, the total profit is of CU695, allocated between the amount recognised on lease commencement and the unearned portion that reduces the carrying amount of the net residual asset.

As this is a Type A lease, the lessor would record the following journal entry at lease commencement:

Lease receivable CU5,076  
Gross residual asset CU1,119  
Equipment CU5,500  
Gain on lease of equipment CU569  
[ $695 \times (5,076 / 6,195)$ ]  
Unearned profit (695 - 569) CU126

*To recognise lease asset, derecognise portion of underlying asset, and recognise gain on lease agreement.*

Lessor A would recognise the following entries at the end of Year 1:

Cash CU1,000  
Interest income ( $5,076 \times 5\%$ ) CU254  
Lease receivable ( $1,000 - 254$ ) CU746

*To recognise receipt of the first annual lease payment.*

Net residual asset CU56  
Interest on residual accretion ( $1,119 \times 5\%$ ) CU56  
*To recognise accretion of residual asset in Year 1*

### **5.2. Type B leases**

Lessors would account for Type B leases in a manner similar to today's operating leases. That is, they would continue to recognise the underlying asset and, at lease commencement, would not recognise a lease receivable (or residual asset) in the statement of financial position or profit in the statement of profit or loss. The underlying asset would continue to be accounted for in accordance with applicable accounting standards.

## **6. Conclusions**

The revised ED would result in fundamental challenges that go beyond just accounting. Some of these are the following:

- *careful judgements and estimates*: the revised ED would require entities to create an inventory of and evaluate their present arrangements; these would be necessary to determine how the proposal would affect the statement of financial position as well as the amount, timing and classification of lease-related revenue and expense to be recognised;

- *data collection and periodic reassessments*: the judgements and estimates required to account for leases under the revised ED would demand knowledge about treasury, corporate real estate, business operations, legal, IT and tax. Therefore, additional personnel may be required to gather the data needed to identify and initially record the lease, to



perform the required periodic reassessments of lease payments and discount rate and assess the impact of lease modifications (Ernst & Young, 2013b, pp. 3);

- *IT systems, processes and controls*: companies will need flexible software applications, and adaptable to changes (Lăzărică and Dediu, 2013, pp. 83); they will need to estimate their software costs;

- *Tax considerations*, especially in the current context in which tax has become a key issue of discussions (Culiță, 2013, pp. 93) [5].

In terms of financial reporting, key financial metrics would be affected by recognising new asset and liabilities. This could impact debt covenants, tax balances and payment of dividends. The proposed requirements would affect any entity that enters into a lease.

## 7. References

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- [4] ED/2011/6 *Revenue from Contracts with Customers* issued by the IASB on November 2011, a revision of ED/2010/6
- [5] According to Culiță (2013), European Union is an area with high level of taxation, therefore entities should carefully evaluate the impact of taxation on present and future leasing arrangements.

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