

LEASE REGULATIONS AND FUTURE TRENDS IN HUNGARY

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Összefoglalás

A globális lízingpiac működése várhatóan 2019-től nagyon jelentős változáson megy majd keresztül az új lízing elszámolási számviteli módszerek hatályba lépésével. A jelenleg mérlegen kívüli tételként megjelenő értékek a lízingbevevő szempontjából jelentősen csökkeni fognak. Magyarországon az IFRS szabályozás befogadásával és a pénzügyi szolgáltató szektorban a kötelező alkalmazással nem tudjuk elkerülni a nemzetközi változás hatásait. Magyarországra vetítve ez a hatás még jelentősebb lehet a többi európai országhoz viszonyítva, mert itthon nem alkalmazzuk még a jelenleg hatályban lévő nemzetközi standardokat sem, ami pedig segítene csökkenteni a mérlegen kívüli tételek nagyságát. További hatása lehet a határon átnyúló lízingszerződéseknek, amelyekről jelenleg nincs hivatalos publikált magyarországi piaci információ. Néhány érintett társaság már elkezdte a felkészülést a várható változásra és ugyanilyen sürgőséggel lenne szükség változásra a magyar szabályozásban.

Kulcsszavak

Lízing szabályozás, IFRS, Magyar Számviteli Törvény, Lízing harmonizáció

Summary

The global operational lease market is expected to go through a significant restructuring starting from 2019 with the new method of lease accounting. The currently off-balance sheet values from lessee perspective are expected to be significantly reduced. In Hungary as a result of the IFRS acceptance and the compulsory IFRS application within the financial sector we cannot avoid these changes. The impact for Hungary could be even more significant compared to other European countries, because we do not even apply the currently effective international standards, which could help to reduce the off-balance sheet financing. There can be an additional impact from cross-border contracts and as of now there is no formally published Hungarian market information. Some of the impacted companies are already starting to prepare for the expected change and this would require urgent changes in the Hungarian national regulation.

Keywords

Lease regulations, IFRS, Hungarian Accounting Law, Lease harmonization

Introduction

The lease regulation in Hungary went through a long debate, which lasted even more than a decade. Complexity of the rules is increased by two different legal definitions, where both laws are effective and the strong connection between the accounting and tax laws. In addition Hungary's lease accounting regulation is not harmonized with the current International Financial Reporting Standards (IFRS). On the other hand starting 2016 Hungary just as other European Union members allowed to apply IFRS first time non-consolidated purposes instead of the Hungarian Accounting Law. In other words it means an opportunity for these entities to solely apply IFRS without the Hungarian Accounting Law.

In the past years international accounting standard setters developed and published completely new standards, which are planned to have a major impact on lease accounting starting from 2019.

In this situation it seems we are facing an exciting period with potentially significant changes. Considering the limitation of this text my intention is to give a 'big picture' and to present on high level the significance of this question.

The importance of lease agreements

Leases are an important element of our daily business even if they are not always visible for all of us. It was actually one of the advantages in addition to tax benefits as it allows a significant 'off balance' financing. In other words the generated liabilities by these transactions are not always visible in the reported financial statements. The overall international impact is estimated as USD 2.18 trillion 'off-balance' figure, which was a shocking number for the whole finance community. It was a strong indicator to revise the lease concept and prepare new regulations for the international practices as International Financial Reporting Standards (IFRS) and US-GAAP.

There were many initiatives and proposals, because the discussion for a necessary change started in 2005 and it took more than 10 years for the International Accounting Standard Board (IASB) to issue a completely new lease IFRS 16 standard in 2016 with a three years preparation period prior to effective date as of January 1st, 2019.

Leases legal definition in Hungary

In Hungary it is not so simple even to properly define the lease terms, because we have them in two separate effective legal regulations:

a) *V. Act of 2013. Polgári Törvénykönyv (Ptk.)*, which can be translated as the Hungarian Code Civil (hereinafter: Ptk.) 6:409 § and

b) *CCXXXVII Act of 2013. Hitelintézetekről és Pénzügyi Vállalkozásokról (hereinafter: Hpt.)* 6 § Section 89

Not itself the lease definition is difficult, but rather the lease type identification and proper classification. As always the devil is in the details. Both regulations define the finance lease type conditions and all other contracts are considered to be operational leases. In spite of the common approach both Ptk. and Hpt. gives different terms for finance leases, which is quite transparent if we compare them.

Ptk. uses similar terms as the IFRS, currently effective IAS 17 five lease conditions. There are several differences between these regulations, but the applied concept is intended to follow IFRS.

Hpt. defines finance lease key criteria as the formal transfer of the ownership or a purchase option, where both of them are legal terms. International lease regulations (IFRS, US-GAAP) already use different terms, because the economic substance of the transaction can be different. In other words it means there are several possibilities in case of a motivation to misuse the concept and wrongly classify the lease types.

Accounting regulation for leases in Hungary

The improper presentation in a legal document gain an economic value if there is a possibility to apply them with benefits in the accounting treatments, therefore we should review how can it be accounted.

The Hungarian Accounting Law (Act. C of 2000) applied Ptk. definition for a long time even before the current IFRS based version. There were several updates in Ptk. since 1989, however in 2014 was the first complete revision and the issuance of a new regulation. The previous one was in force since 1959. Among other sections the update in the lease definition was long time expected, but due to the complexity it took several years to update this law.

In March 2014 Ptk. applied first time the IFRS based definition and after there was a sudden change in the accounting regulation. Since 2015 finance lease definition for accounting is based on the Hpt. definition and as a result the accounting records applies the same classification as it is defined by the legal terms of formal ownership change or purchase option.

In case if a company would like to avoid capitalizations or would not like to present lease obligations (liabilities) and account lease payments as expenses with the operational lease terms it is possible to do so. It does not generate a positive impact on the total financial profit, however it does have a decreasing impact on the corporate income tax, debt ratios and it can have other tax benefits.

Potential taxation impacts

One of the most significant advantages of the lease agreement is the tax advantage compared to other finance contracts. Even within the different lease conditions these impacts can be various. From the tax perspective I would like to only highlight one tax impact, which would be actually the Withholding Tax (VAT) with a 27% general rate in Hungary.

The operational lease is considered similar to a rental agreement, which means this transaction is handled as a rental service, where the VAT is normally deductible after the invoice issuance.

From financial lease perspective there is an additional `special` classification only applied in Hungary as `Open` or `Close-end` finance lease agreement. The `close-end` agreement is defined with by the determined ownership transfer at the end of the lease term and therefore it is treated in the VAT as a purchase contract, which means at the beginning of the lease agreement the whole VAT on the leased asset needs to be paid and it can only be deducted if the transaction is completed, which means the end of the lease period. This requires in some cases significant cash-flow financing from the lessee company. On the other hand the open-end finance lease contract normally allows VAT deduction at the periodic invoice issuance. There is also opportunity in some cases to reclaim VAT after a passenger car, which is used as a company car, which means additional tax advantage.

Why should we care about deviations from international regulations?

Both IFRS and US GAAP regulations are focused to identify the substance of the transactions over legal forms. In 2006 as mentioned in the introduction both of them jointly initiated a complete renewal on the lease standards, because standard setters identified the importance of the not reported lease obligations in the financial statements. They jointly developed and announced completely new regulations, which is going to generate significant changes in the lease accounting in the upcoming years.

The Hungarian regulations are not following even the current standards and not mentioning the future expected significant changes. We should care about these regulations, because the IFRS acceptance in Hungary. We cannot avoid the fact as starting from 2016 it is

a possibility even for non-listed companies to apply IFRS instead of the Hungarian Accounting regulations and therefore we should expect also a significant change once the already announced standards became effective.

IFRS application in Hungary

IFRS application in Hungary is a result of a long procedure, where with the 1387/2015 Government order as of June 12th, 2015 took initial steps towards the implementation on the individual IFRS reporting in Hungary. Just to put into perspective the due date for these government actions was setup until June 30th, 2015. Certainly it is a favorable step towards the international harmonization, but we can also conclude as a last minute decision.

Until the 2017 calendar year we should also have a look on the impact of the IFRS applications in Hungary. According to the latest publications¹ currently there are 127 companies who are reporting based on IFRS compared to the total registered 400 841 companies, which represents an approximate figure of 0.03%. We might think it is a very low figure, however from tax payments perspective these companies paid 1 825 372 million HUF in total last year. As a rough comparison in 2016 the direct state central budget income for Corporate Income Tax was expected as 400 500 million HUF². Please find below a table for comparison:

1 Table: Comparison of tax contributions from IFRS reporting companies vs. 2016 State central incomes

Description	Value (million HUF)
127 IFRS based companies tax contributions	1 825 372
Corporate Income Tax (CIT) revenue in 2016	400 500
Direct tax incomes from corporations in 2016 (Including CIT)	963 400

Source: Own editing (Számvitel, Adó Könyvvizsgálát and 2016 Central State Budget)

We can conclude that the number of IFRS based companies is currently limited, however the impacts of these companies are very significant on the Hungarian economy. The other important change since 2016 as the financial sector, where the lease companies are operated must apply IFRS latest by 2018.

Hungarian Lease market in numbers

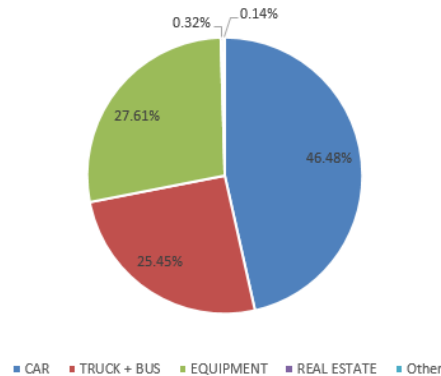
Prior to any further conclusions I would like to present a big picture on the Hungarian Lease market and the type of the agreed contracts.

The Hungarian Lease market data is consolidated and published by the Hungarian Lease Association. According to these information in 2015 full year the financed Lease value in Hungary amounted to 524 449 Million HUF. It would be more appropriate to classify into finance and operational lease the gross asset value, which is amounted to 727 617 Million HUF, however it was not an available public information. It also has to be added as a general notice that Hungarian lease market overall increased by approx. 9% in 2016 compared to the previous year. For 2016 operational and finance lease classification was also not available until now.

¹ Számvitel Adó Könyvvizsgálát – 2017/02 – „IFRS implementation from the Tax Authority perspective”

² Act C of 2015 On 2016 Central State Budget – Section XLII.

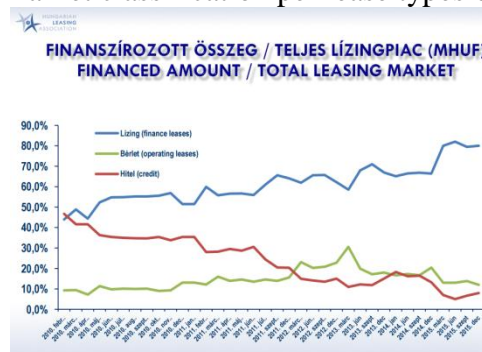
1. Diagram: Hungarian Lease Market in 2015 total financed value per asset types



Source: Hungarian Lease Association 2015 www.lizingszovetseg.hu

Based on the available information the operational lease contract type has an approx. 10-11% market share, which is resulted in a rounded 53 billion HUF financed value contracted by Hungarian Lease companies within Hungary.

2. Diagram: Lease market classification per lease types on financed amount



Source: Hungarian Lease Association 2015

53 Billion HUF is not an immaterial figure for off-balance finance, however let`s see an example whether this population can be presented in a different light.

Examples

In order to demonstrate the importance and the impact of the proper presentation off-balance sheet financing please find below a specific example related to Hungary.

For the demonstration I would like to select an operational lease for a company car, which could be a very usual transaction and in addition it is very probable that even small companies would need such equipment.

The selected vehicle is a Skoda Superb with the procurement costs of 10 000 000 HUF³ (approx. 33K EUR) and these conditions are calculated according to average usage and no specific incentives for operational lease type. The duration is planned for 5 years (60 months) with a starting 20% portion. Based on these specifications the monthly lease payment fee would be: 148 548 HUF/month + VAT. For the simplification the lease contract is calculated on local currency base to avoid any foreign exchange risk or additional cost. For the Net Present Value calculation I applied the Hungarian National Bank (MNB) last 3 years average rate, which is 1.5%.

Out of the five IFRS/US-GAAP key lease classification criteria I would like to only highlight one condition from IAS 17 Section 10 d) *at the inception of the lease the present*

³ Financial conditions are based on an offer from a Hungarian lease company. (March 2017)

value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset'. Even if one criteria is fulfilled from the five conditions the lease should be classified financial lease.

Please find a short calculation below:

- Annual interest rate conversion to monthly: $12\sqrt[12]{(1,0105)} = 0,087\%$ monthly interest rate.

- At the inception of the lease the present value of the minimum lease payments amounts to: Initial payment + Net Present Value (NPV) of the monthly payments = 1 574 803 HUF + $C/r \times (1 - (1/(1+r)^n)) = 148.548/0,00087 \times (1 - (1/(1,00087)^{60})) = 1 574 803 \text{ HUF} + 8 680 571 \text{ HUF} = 10 255 374 \text{ HUF}$

- Comparing the NPV of minimum lease payments to the initial purchase price:

$10 255 374 \text{ HUF} / 10 000 000 \text{ HUF} = 103\%$

Based on the standard lease conditions it can be concluded that at the inception of the lease the present value of the minimum lease payments even exceeded the net present value of the asset and according to the IFRS standards this agreement should be classified as a finance lease even if the contract is named as operational lease, however as per the current Hungarian regulation it is classified as an operational lease with VAT deduction and off-balance financing for the company.

The next section includes the cross-border leases, which was a famous topic several year ago, when companies or individuals were driving cars with foreign registration plates. The government at that time communicated openly to the public their intention to stop these type of contracts, but they remained a legal option for the companies.

In addition to this simple example I would like to add that other asset types can be even more important and significant than cars like Airplanes, Trucks, real estate and others.

Cross-border agreements

Based on the EU regulations the cross-border lease agreements are absolutely allowed and if it is an operational lease these liabilities are not appearing in the balance sheet of a Hungarian entity in line with the Hungarian Accounting Law.

The Hungarian Lease Association measures only the domestic Hungarian lease agreements. Cross-border finance lease agreements might be visible in the lessee financial statements and annual reports especially if they represent a significant value, however the operational leases are mainly presented as services and they are not really visible. It is difficult to measure, but certain existence of such contracts can be proven.

According to the reported asset types by the Hungarian Lease Associations airplane leases in 2015 and 2016 were reported as zero. So we might think on the Hungarian market there are no airplane, but actually we have one remaining airline company called Wizz Air.

In the annual report of Wizz Air Hungary Kft., which is a Low-Cost Carrier Airline several comments presents as they entered into lease agreements. This company in the past was operated from Hungary, but currently since 2010 it is operated from Switzerland and it is part of the Wizz Air Holding Plc.

Wizz Air Hungary Kft 2015. Annual Report presented 449.06 Million EUR (for comparison 139 163 Million HUF⁴) cost of services related to primary activities, included: Airport fees, Lease costs, maintenance costs. The Hungarian Accounting Law does not apply further reporting requirements so therefore it is not possible to receive additional public information, but fortunately the parent company Wizz Air Holdings Plc prepares an IFRS based annual report and there we find very interesting lease figures.

⁴ Hungarian National Bank 2015 average rate: 309.9 HUF/EUR

Wizz Air Holdings Plc reported in 2016 the total minimum lease payments under non-cancellable operating lease rentals as follows:

2. Table: Wizz Air Holdings Plc non-cancellable operational lease liabilities

	2016	2015
Payments due:	EUR million	EUR million
Within one year	244.8	218.7
Between one and five years	950.1	817.7
More than five years	563.5	455.8
Total operating lease commitments	1 758.3	1 492.2

Source: 2016 Annual Report – Wizz Air Holdings Plc.

The company also reported as the majority (97%) of the commitments relate to aircraft operating lease contracts. If we calculate that should be: 1 758.3 Million EUR * 97% * 311.46⁵ = 531.21 Billion HUF. That would actually even slightly exceed the total reported Hungarian Lease Market value. It also has to be noted all of those items are considered as operational leases and it was only one company.

Cross border leases therefore has to exist in Hungary even if we are not able to measure the total value of these contracts.

Summary and preparation for change

Considering the upcoming new lease standard effective date even IASB prepared a summary on the key important actions and the expected difficulties. The major multinational companies are already preparing for the change for instance Wizz Air Holdings Plc. presents in the annual statement, which is just an example and only company.

From the Hungarian legislation perspective there is already a quite significant delay in the necessary harmonization. It would be required to apply the same standards and definitions between the `internal` domestic effective laws and also an `external` harmonization to the international standards.

At the moment there is no visible communication on these expected future changes. It is a personal point of view and I do remark to read in a domestic Hungarian article from 2016 the opposite conclusion as no changes are expected for operational leases especially for car fleets.

We can certainly ask the question what can be done from the legislation perspective. Certainly further research would be highly desired on this topic, but I think we can already define three very straight forward goals for legislators:

- 1) Communicate to market participants on the expected changes and initiate a research how to change the national legislation to be harmonized on domestic level and to the international lease regulations especially after 2019.
- 2) Provide an impact analysis on the expected changes to the market.
- 3) Initiate a research whether the change would even require to create a legislation on new lease products.

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