This accounting policy paper is based on IPSAS 13 Leases, as adopted by the Treasury of the Republic of Cyprus.

Leases

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1. INTRODUCTION

1.1 PREAMBLE

Leasing is an important source of medium-term and long-term financing, which can have a significant impact on lessee's and lessor's financial statements. Leases must be classified at inception as either finance or operating leases based on the substance of the transaction and not on the legality of the transaction (i.e. the form of the contract).

IPSAS 13 Leases, defines a lease as:

> *An agreement wherby the lessor conveys to the lessee, in return for a payment or a series of payments, the right to use an asset for an agreed period of time.*

1.2 OBJECTIVES

The objective of this accounting policy is to prescribe the appropriate accounting treatment and disclosures to apply in relation to finance and operating leases, on both sides, the lessee and the lessor. The aim of this policy is to provide technical accounting guidance for the preparation of financial statements, so as to enable them to give a true and fair view. The aforementioned policy is prepared following guidance from all relevant International Public Sector Accounting Standards (IPSASs).

1.3 SCOPE

This accounting policy applies for the accounting treatment of leases in the financial statements of the Republic of Cyprus and its consolidated entities, as these are defined in the relevant accounting policy, except for:

a) Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources; and

b) Licensing agreements for such items as motion picture films, video recording, plays, manuscripts, patents and copyrights.

Nevertheless, this accounting policy shall not be applied as the basis of measurement for:

a) Property held by lessees or lessors that is accounted for as investment property (see Accounting Policy on Property, Plant and Equipment); or

b) Biological assets held/provided by lessees or lessors

This accounting policy applies to agreements that transfer the right to use assets, even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. However, the aforementioned accounting policy does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Additionally, this accounting policy applies to contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions.

1.4 DEFINITIONS

This accounting policy uses the terms as expressed within the relevant IPSAS with the following meanings:

Commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e., the recognition of the assets, liabilities, revenue, or expenses resulting from the lease, as appropriate).

Contingent rent is that portion of the lease payments that is not fixed in amount, but is based on the future amount of a factor that changes other than with the passage of time (e.g., percentage of future sales, amount of future use, future price indices, future market rates of interest).

Economic life is either:

a) The period over which an asset is expected to yield economic benefits or service potential to one or more users; or
b) The number of production or similar units expected to be obtained from the asset by one or more users.

Finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Gross investment in the lease is the aggregate of:

a) The minimum lease payments receivable by the lessor under a finance lease; and
b) Any unguaranteed residual value accruing to the lessor.

Guaranteed residual value is:

a) For a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
b) For a lessor, that part of the residual value that is guaranteed by the lessee, or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

a) A lease is classified as either an operating or a finance lease; and
b) In the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The **Initial direct costs** are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or trader lessors.

The **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of:

a) The minimum lease payments; and
b) The unguaranteed residual value

to be equal to the sum of (i) the fair value of the leased asset, and (ii) any initial direct costs of the lessor.

A **Lease** is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time.

Lease term is the non-cancellable period for which the lessee has contracted to lease the asset, together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Minimum lease payments are the payments over the lease term that the lessee is, or can be, required to make, excluding contingent rent, costs for services and, where appropriate, taxes to be paid by and reimbursed to the lessor, together with:

a) For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
b) For a lessor, any residual value guaranteed to the lessor by:
   i. The lessee;
   ii. A party related to the lessee; or
   iii. An independent third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

A **non-cancellable lease** is a lease that is cancellable only:

a) Upon the occurrence of some remote contingency;
b) With the permission of the lessor;
c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
d) Upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

An **operating lease** is a lease other than a finance lease, meaning that the risks and rewards incidental to ownership are not transferred to the lessee.

Unearned finance revenue is the difference between:

a) The gross investment in the lease; and
b) The net investment in the lease.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realization of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits or service potential embodied in the asset are expected to be consumed by the entity.

Any other terms defined in other accounting policies that have been adopted by the government of the Republic of Cyprus have the meaning presented in these accounting policies.

2. CLASSIFICATION OF LEASES

As previously stated, a lease can be classified either as a finance lease or an operating lease. The classification of a lease into finance or operating lease is based on the extent to which risks and rewards related to ownership of a leased asset stand with the lessor or the lessee. Substantially, the party that bears the risks and rewards of the leased asset should be considered as the owner of the asset, therefore the leased asset should be accounted from that party's financial statements. The lease classification is considered to be very important due to the fact that it drives the accounting treatment of the lease, as described in section 3 Accounting for Leases. Therefore, specific attention shall be given to the terms and clauses of the lease agreement.

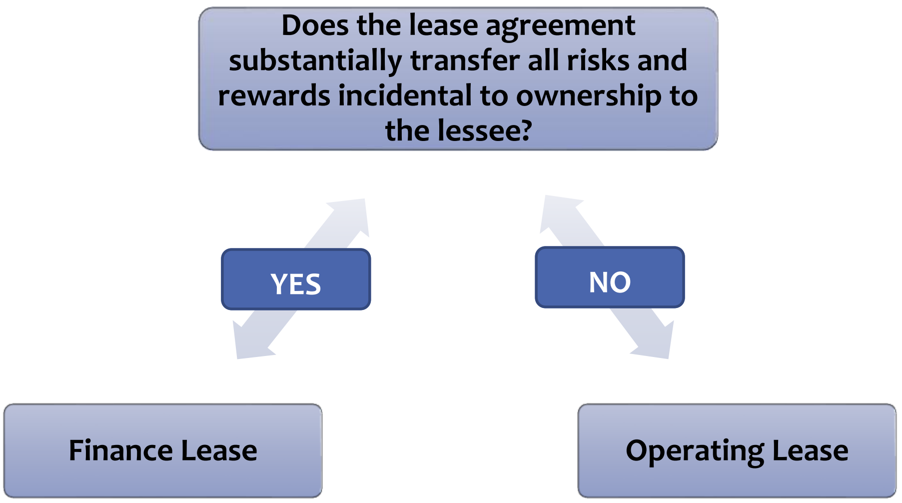


Figure 1: Lease Classification

2.1 FINANCE LEASE VS OPERATING LEASE

2.1.1 *FINANCE LEASE*

A leased asset shall be classified as a finance lease if, and only if, the lease agreement transfers substantially all risks and rewards to the lessee. Examples of situations that would normally lead to the classification of the leased asset into a finance lease are indicated below, even though these examples can lead either separately or in combination to the classification of the lease:

a) The lease **transfers ownership of the asset** to the lessee by the end of the lease term;

b) The lessee has the **option to purchase the asset** at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised;

c) The lease term is for the **major part of the economic life of the asset**, even if title is not transferred;

d) At the inception of the lease, the **present value of the minimum lease payments amounts to** at least substantially all of the **fair value** of the leased asset;

e) The lease assets are of a **specialised nature** such that only the lessee can use them without major modifications being made;

f) The leased asset **cannot easily be replaced** by another asset.

Additionally, some other circumstances which may lead to the classification of a lease shall be classified as a finance lease are:

a) If the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

b) Gains or losses from fluctuations in the fair value of the residual accrue to the lessee (for example, by means of a rent rebate equalling most of the sales proceeds at the end of the lease);

c) The lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.

2.1.2 *OPERATING LEASE*

If the lease agreement **does not transfer** substantially all risks and rewards incidental to ownership, then it shall be classified as an operating lease. Consequently, in the absence of the above examples of circumstances, a lease can be classified as an operating lease.

Additionally, below are examples of situations that would normally lead to a lease being classified as an operating lease:

a) If ownership of the asset, is transferred at the end of the lease for a variable payment equal to asset's then fair value at the end of the leased period;

b) If there are contingent rents as a result of which the lessee does not have substantially all such risks and rewards.

Appendix 1 shows the process to classify a finance and an operating lease.

2.2 GENERAL PROVISIONS AND RECLASSIFICATION

Usually the inception date of the lease is generally the date on which the lease agreement is signed by the lessee and the lessor. Commencement date of the Lease may be expressed as the date on which the lessee can exercise the right to use the asset.

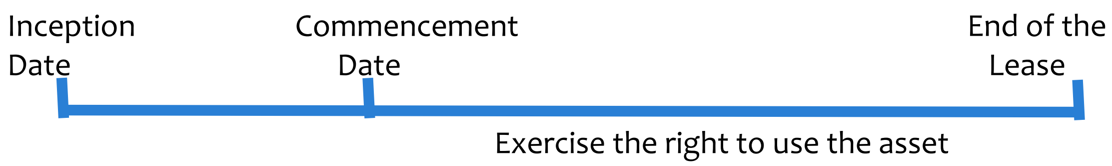


Figure 2: Lease Term

For the purpose of this accounting standard, any changes made to adjust the lease payments, according to the provisions of the lease agreement, between the inception of the lease and the commencement of it, shall be considered as part of the lease at inception. Such adjustments may include changes in the construction or acquisition cost of the leased assets, changes in other measures determining the cost or value of the leased asset like general price level, cost of financing the lease by the lessor etc.

Lease classification is made at the inception of the lease. If at any time, the lessee and the lessor agree, to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraph 2.1 above if the changed terms had been in effect format the inception of the lease, the revised agreement is regarded as a new agreement over its term.

Any changes in estimates (e.g. change in estimates regarding the economic life or the residual value of the leased asset) or changes in circumstances (e.g. default by the lessee) do not give rise to reclassification of the leased asset.

2.3 LEASE FOR LAND AND BUILDING ELEMENTS

In cases where a lease agreement includes both land and buildings elements, then the entity shall assess the classification of each element separately, either as a finance or an operating lease according to the provisions of this accounting policy.

An important indicator for classifying the land element as an operating or a finance lease is that land has an indefinite economic useful life. Therefore, the land element of the lease will normally be classified as an operating lease, unless there is a term indicating the transfer of ownership to the lessee at the end of the lease.

Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease. In case where the amount to be recognised for the land element is considered as being immaterial, then the lease for a land and building may be treated as a single unit for classification purposes and the useful economic life of the leased asset would be based on the useful economic life of the building.

3. ACCOUNTING FOR LEASES

The accounting treatment for leases differs according to the lease classification and the party who accounts for the lease. Figures 3 & 4 briefly summarise the effect of the two types of leases on the statement of financial position and statement of financial performance of the lessee and the lessor.

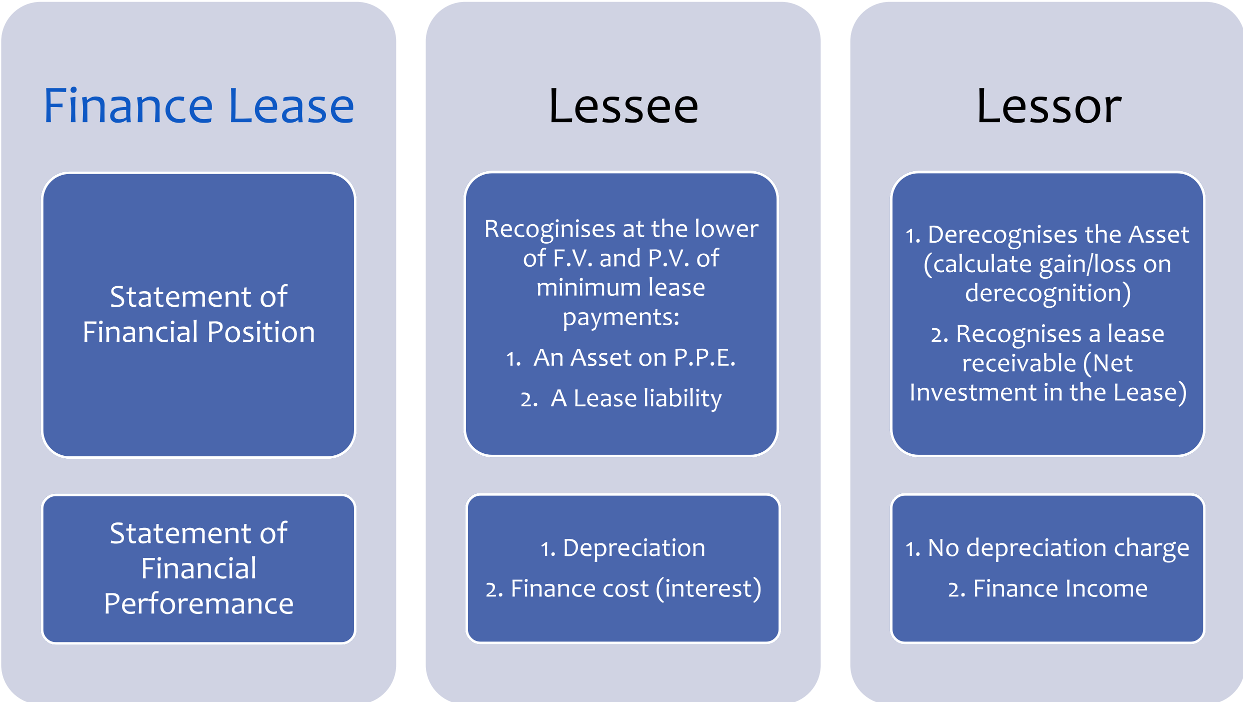


Figure 3: Accounting for Finance Leases

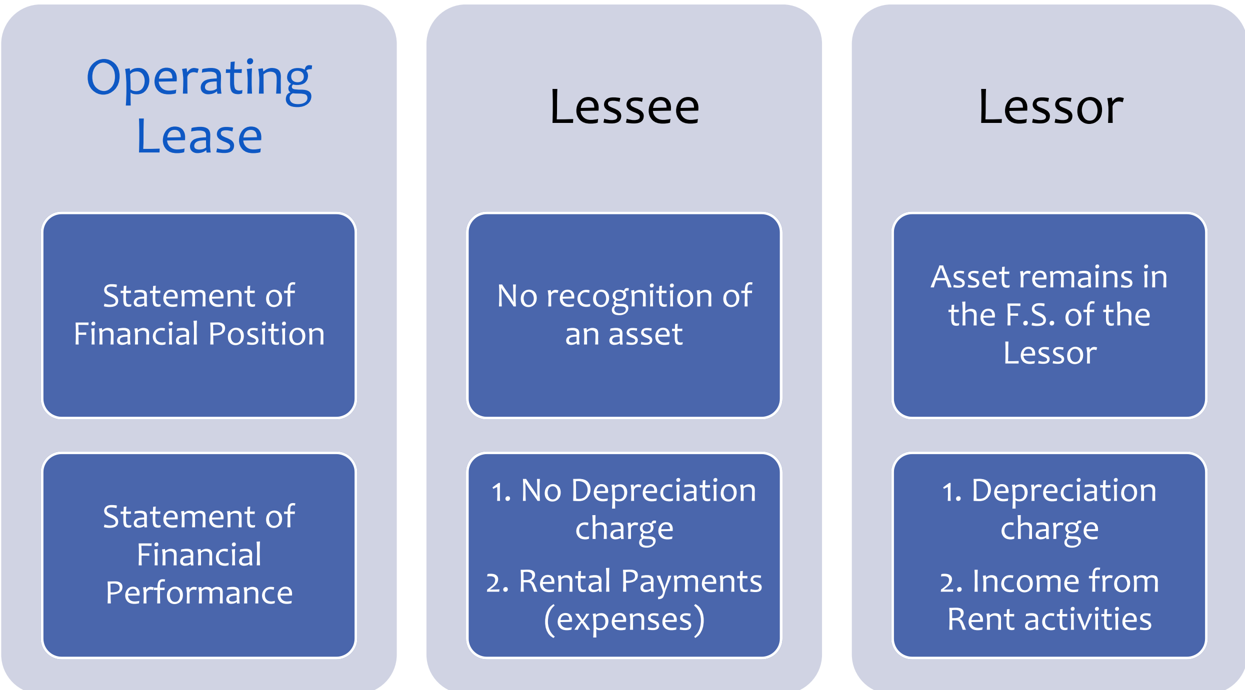


Figure 4: Accounting for Operating Leases

3.1 LEASES IN THE FINANCIAL STATEMENT OF LESSEES

Lessee is the party to whom the lessor conveys the right to use the asset.

3.1.1 FINANCE LEASE

At the commencement of the lease term, finance leases shall be recognised as an asset and all associated obligations as a liability (i.e. the obligation to pay future lease payments). The recognised amount shall be the lower of the fair value of the leased asset and the present value (PV) of the minimum lease payments each determined at inception of the lease. The present value of the minimum lease payments shall be discounted at the interest rate implicit in the lease, if practicable, or else at the lessee's incremental borrowing rate (i.e. the rate it would have to pay on a similar lease or on borrowings over a similar term with similar security).

The Present Value (PV) of the minimum lease payments (MLP) is calculated by means of the following formula:

$$PV(MLP) = \frac{S}{(1+r)^n} + \frac{A}{r}\left(1 - \frac{1}{(1+r)^n}\right)$$

Where S is the guaranteed residual value
A is the regular periodical payment
r is the periodic interest rate implicit in the lease expressed as a decimal
n is the number of periods in the term of the lease

At the commencement of the lease the recognised asset and liability as presented in the financial statement are at the same amounts, except for any initial direct costs of the lease that can be capitalised and recognised as an asset.

Initial Costs

Any initial costs directly related to the leased asset and leasing activities (e.g. negotiating and securing leasing arrangements), incurred by the lessee, are recognised as an asset at inception.

Depreciation

An asset recognised under a finance lease shall be depreciated over the shorter of the lease term and the leased asset's useful life, unless there is a certainty that the lessee will obtain legal ownership of the asset by the end of the lease agreement; in such a case the asset shall be depreciated in accordance with relevant Accounting Policies on Property, Plant and Equipment and Intangible Assets, as appropriate.

Minimum Lease Payments

The lease payments shall be allocated into two components:

1. A finance charge - allocated to the lease periods, maintaining a constant periodic rate of interest on the remaining balance of the lease liability; and
2. A reduction of the (outstanding) liability.

Contingent rents shall be expensed in the period in which they are incurred, therefore are not part of the finance charge liability.

Impairment of finance lease assets

Finance leased assets are subject to impairment in accordance with the provisions of the Accounting Policy on Impairment of Cash and Non-Cash Generating Assets.

(**Appendix 2** and **Example 1** are relevant, illustrating the accounting flow and accounting treatment of a finance lease, from lessee's perspective).

3.1.2 OPERATING LEASE

Assets held under an operating lease shall not be recognised and accounted for as assets in the financial statements of the lessee. On the contrary, lease payments shall be recognised as an expense on a straight line basis over the lease term, except where another systematic basis is representative of the time pattern of the user's benefits (see Examples 3 & 4).

3.2 LEASES IN THE FINANCIAL STATEMENT OF LESSORS

The lessor is the party that conveys to the lessee the right to use assets.

3.2.1 FINANCE LEASE

Public sector entities may enter into a finance lease as lessors under a variety of circumstances, for example finance leases of land and buildings, machineries.

In cases where the lessor substantially transfers all risks and rewards incidental to legal ownership to the lessee and the lease can be classified as a finance lease, as indicated in paragraph 2: Lease Classification, then the lessor shall derecognise the leased asset from the entity's statement of financial position; in continuation the lessor shall recognise lease payments receivable under a finance lease.

Lessors shall recognise lease payments receivable under a finance lease as assets in their statements of financial position. They shall present such assets as a receivable at an equal amount to the net investment in the lease. For the purpose of this accounting policy, net investment of the lease is the lessor's gross investment in the lease discounted by the interest rate implicit in the lease. The lessor's gross investment in the lease is the sum of the minimum lease payments and the unguaranteed residual value accruing to the lessor.

Initial recognition

Initial direct costs are often incurred by lessors, and include amounts such as commissions, legal fees, and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads, such as those incurred by a sales and marketing team. For finance leases other than those involving manufacturer or trader lessors, initial direct costs are included in the initial measurement of the finance lease receivable, and reduce the amount of revenue recognised over the lease term

The lessor shall recognise a finance revenue on a pattern reflecting a constant periodic rate of return on net investment in the finance lease (See Appendix 3 and Example 2).

Manufacturer or trade lessor

There may be cases where a public sector entity manufactures and trades assets on a regular basis, giving the opportunity to third parties of either leasing or buying an asset. In case of finance leasing the transaction gives rise to two types of revenue to the manufacturer or trader:

1. The gain or loss equivalent to the gain or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

2. The finance revenue over the lease term.

When a manufacturer or trade lessor enters into a finance lease agreement, the asset is transferred from inventory, thus the sales revenue would be recognised in the period of the sale and finance revenue will be earned over the term of the finance lease.

The sales revenue to be recognised amounts to the lower of the fair value of the asset and the present value of the minimum lease payment accruing to the lessor (i.e. the amount recognised by the lessee excluding any initial costs) discounted at a commercial rate of interest. The cost of sale of an asset recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased property, less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the gain or loss.

When a manufacturer or trade lessor provides an asset under a finance lease at an artificially low rate of interest, the gain or loss on sale of the asset will be limited to the gain or loss that would have been earned if a market rate of interest was used.

Any costs incurred by manufacturer or trader lessor regarding the arrangement of the lease are recognised as an expense when the gain/loss is recognised (See Appendix 3).

3.2.2 OPERATING LEASE

An asset being classified as an operating lease shall be presented on the lessor's statement of financial position, according to the asset's category. Accounting Policies on Property, Plant and Equipment, Intangible Assets and Impairment of Cash and Non-Cash Generating Assets are therefore applicable on operating leased assets.

Revenue arises through an operating lease shall be recognised as revenue on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefits derived from the leased asset is diminished.

Initial costs

Any initial direct costs incurred by the lessor in negotiating and arranging the lease shall be capitalised on the leased asset's carrying amount and recognised as an expense over the lease term (following the same basis as the lease revenue, either the straight line basis or another systematic basis which is considered as being more representative) (Example 5 is relevant).

Depreciation

An asset held under an operating lease shall be depreciated in consistency with the existing depreciation policy on similar assets, therefore Accounting Policies on Property, Plant and Equipment and Intangible Assets, apply.

Impairment of finance lease assets

Assets held under an operating lease are subject to impairment in accordance with the provisions of the Accounting Policy on Impairment of Cash and Non-Cash Generating Assets.

3.3 SALE AND LEASEBACK TRANSACTIONS

A sale and leaseback transaction entails the sale of an asset and the leaseback of that specific asset through a lease agreement. The leaseback transaction may result in either a finance lease or an operating lease, depending of the substance over form of the leaseback transaction, i.e. depending on the type of the lease involved.

3.3.1 FINANCE LEASEBACK

If the leaseback transaction can be classified as a finance lease, meaning that the seller (the lessee) retains all risks and rewards incidental to ownership of the asset, then the seller (the lessee) shall not recognize a gain or loss on the year of sale and leaseback. Instead, if a gain or loss arises, it shall be deferred and amortized over the lease term.

Gain or Loss = Sale Proceeds – Carrying Amount of Asset

3.3.2 OPERATING LEASEBACK

If the leaseback transaction can be classified as an operating lease, meaning that the seller (the lessee) disposes of all risks and rewards incidental to ownership to the buyer (the lessor), then any gain or loss arising from the sales transaction shall be recognised according to the situations below:

a) If the sales transaction is made on an arm's length basis (e.g. close to asset's Fair Value) any apparent gain or loss shall be recognised in the statement of financial performance.

b) If the sales transaction is made below the Fair Value, any gain or loss arises shall be recognised immediately except that, if the loss is compensated by future lease payments below the market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

c) If the sales transaction is made above the Fair Value, any apparent excess (gain) over fair value shall be deferred and amortized over the period for which the asset is expected to be used.

4. DISCLOSURES

4.1 DISCLOSURES BY LESSEES

4.1.1 FINANCE LEASES

Disclosures on finance leases shall encompass the following:

a) The net carrying amount for each class of assets at the reporting date;

b) A reconciliation between the total of future minimum lease payment at the reporting date, and their present value; indicating the amounts in three periods

i) within one year,

ii) later than one year and less than five years and,

iii) later than five years;

c) The basis on which contingent rent recognised as expense in the period;

d) The total of future minimum sublease payments expected to be received under non-cancelable subleases at the reporting date; and

e) A general description of the lessee's material leasing arrangements including, but not limited to, the following:

i. The basis on which contingent rent payable is determined;

ii. The existence and terms of renewal or purchase options and escalation clauses; and

iii. Restrictions imposed by lease arrangements, such as those concerning return of surplus, return of capital contributions, dividends or similar distributions, additional debt, and further leasing.

f) The disclosure requirements as adopted and described in Accounting Policies on Property, Plant and Equipment, Impairment of Cash and Non-Cash Generating Assets and Intangible Assets shall be applied for finance lease assets presented as acquisitions of assets.

4.1.2 OPERATING LEASES

Disclosures on operating leases shall encompass the following:

a) The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

i) within one year,

ii) later than one year and less than five years, and

iii) later than five years;

b) Lease and sublease payments recognised as an expense in the period, indicating the amounts for minimum lease payments, contingent rents, sublease payments etc. separately;

c) Description of (material) lease arrangements including. But not limited to, the following:

i. The basis on which contingent rent payments are determined;
ii. The existence and terms of renewal or purchase options and escalation clauses; and
iii. Restrictions imposed by lease arrangements, such as those concerning return of surplus, return of capital contributions, dividends or similar distributions, additional debt, and further leasing.

4.2 Disclosures by Lessors

4.2.1 *Finance Leases*

Disclosures on finance leases shall include the following in the notes of the lessor's statement of financial position:

a) A table reconciling the total gross investment in the lease at the reporting date and the present value of minimum lease payments receivables at the reporting date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the reporting date, for each of the following periods:

i) within one year,
ii) later than one year and less than five years and,
iii) later than five years;

b) Unearned finance revenue at the reporting period;

c) The accrued unguaranteed residual values to the benefit of the lessor;

d) The accumulated allowance for uncollectible minimum lease payments receivable;

e) Any contingent rents recognised in the statement of financial performance for the reporting period; and

f) Description of material operating lease agreements regarding the lessor's arrangements.

4.2.2 *Operating Leases*

Disclosures on operating leases shall encompass the following in notes of the lessors' statement of financial position:

a) The future minimum lease payment at the reporting date, under a non-cancellable operating lease, in the aggregate and for each of the following periods:

i) within one year,
ii) later than one year and less than five years and
iii) later than five years;

b) Any amount of contingent rent recognised in the statement of financial performance in the period; and

c) A general description of the lessor's leasing arrangements.

5. TRANSITIONAL PROVISIONS

At the date of adoption of IPSAS all existing leases shall be classified as either finance leases or operating leases according to the substance over form of the transaction of each lease at inception time, to the extent that these are known on the date of adoption of IPSASs.

In cases where the lessee and the lessor have agreed to change the provisions of the lease, at any time before the date of adoption of accrual basis IPSASs, in a manner that would have resulted in a different classification of the lease, then, the revised agreement should be considered as a new agreement.

6. EFFECTIVE DATE

This rule shall be effective for annual financial statement covering periods beginning on or after 1 January 2020.

7. REFERENCES

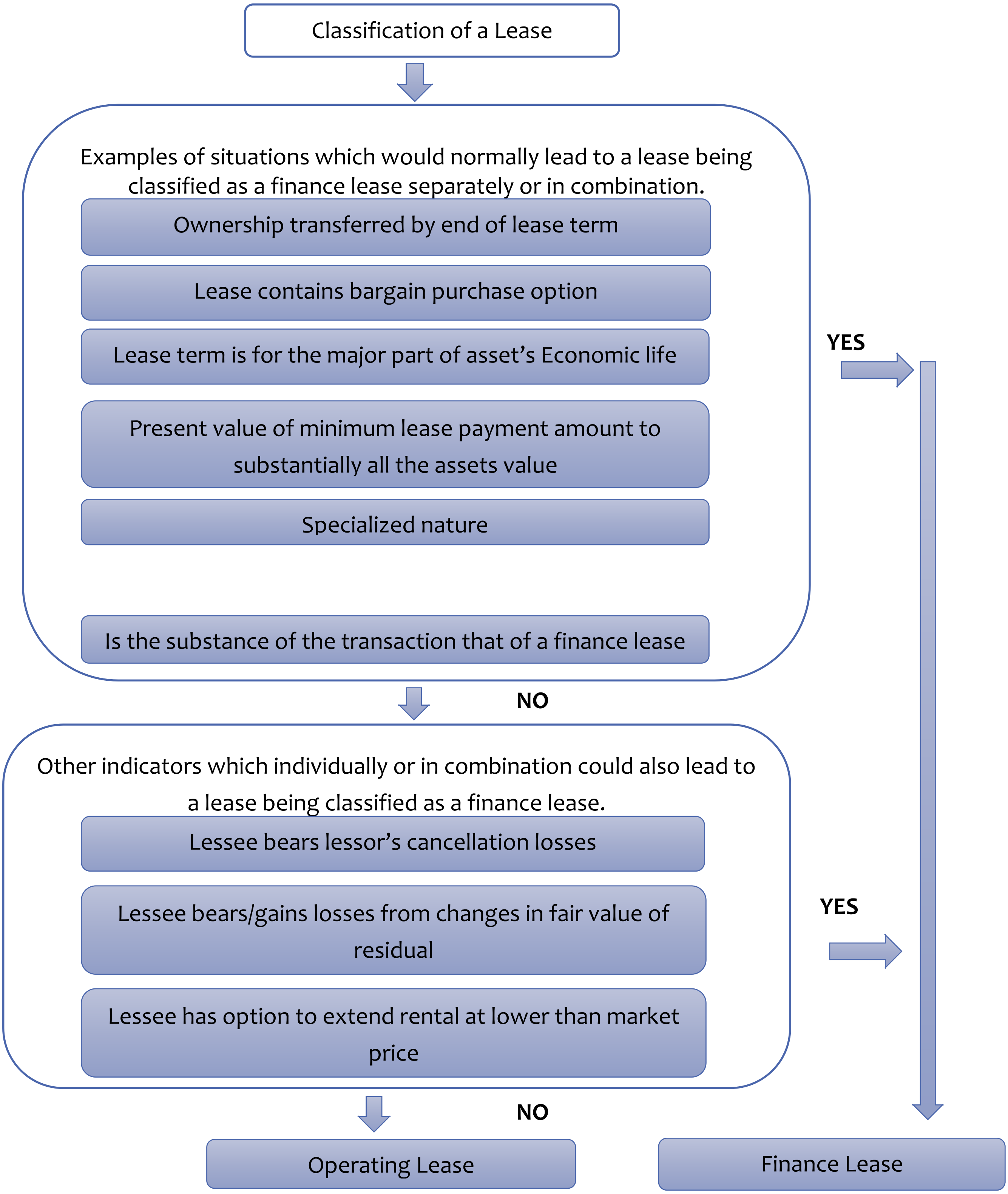
This accounting policy is based on the following IPSAS standards:

IPSAS 13 Leases

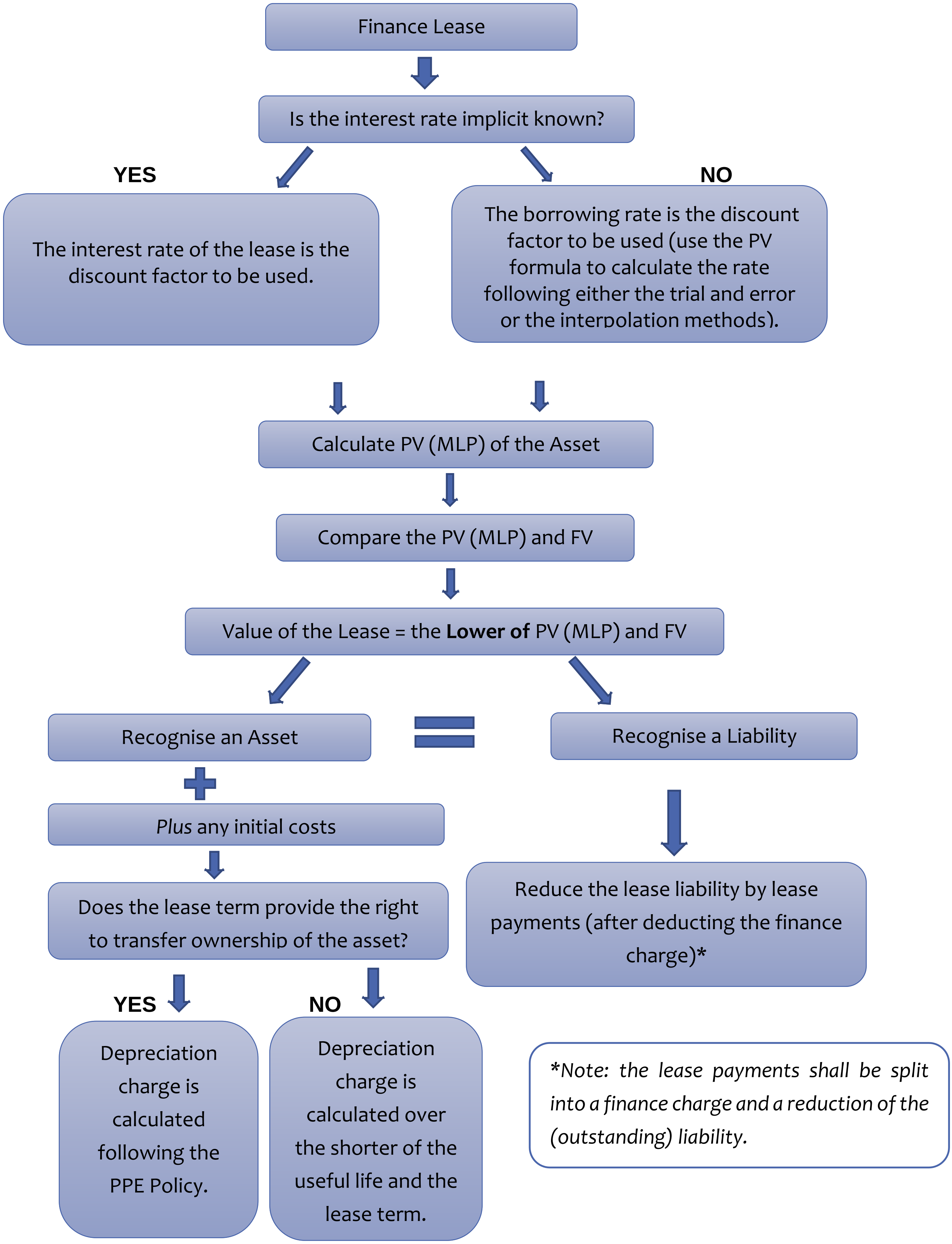
IPSAS 33 First – time Adoption of Accrual Basis IPSASs.

8. APPENDICES

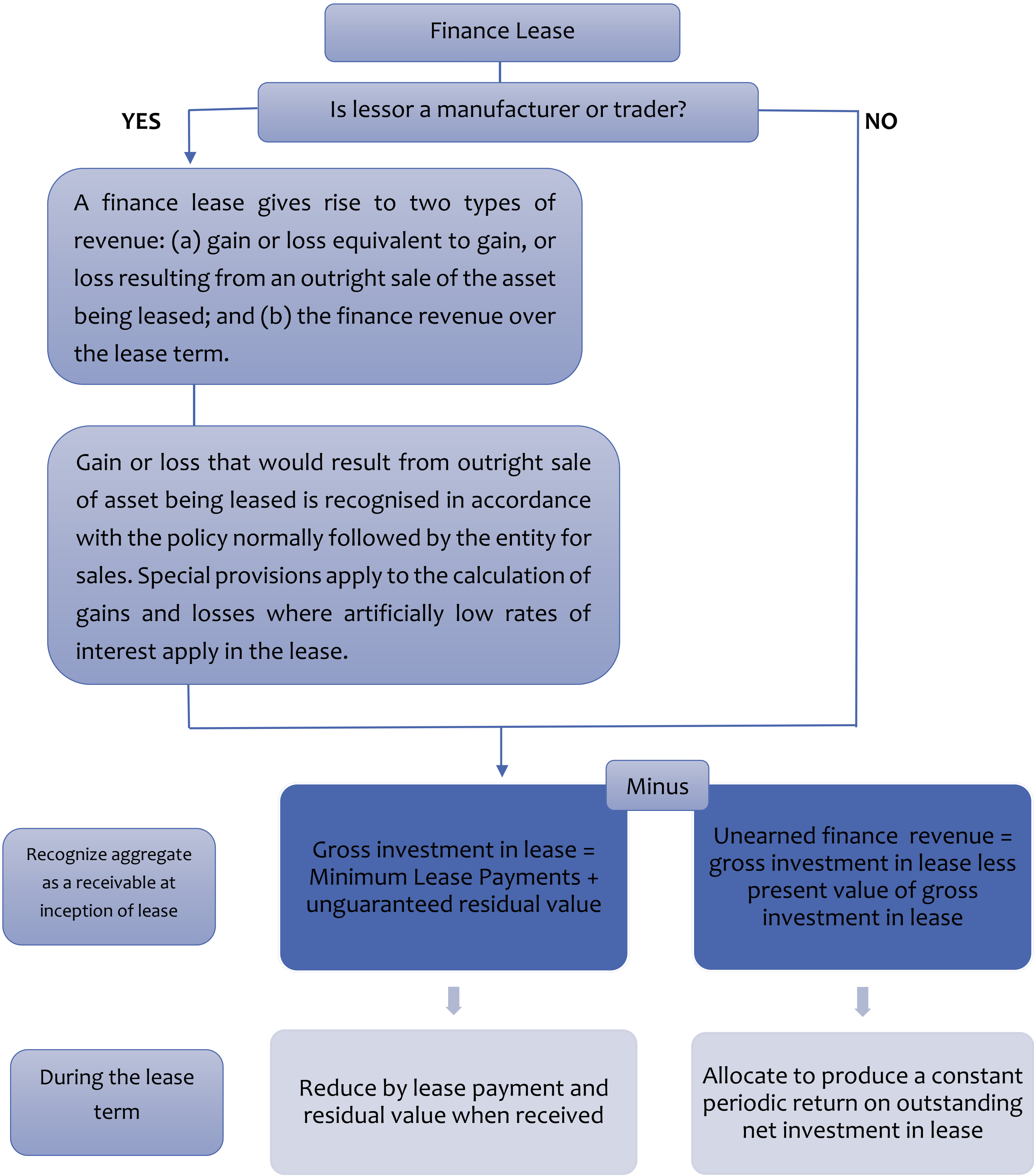
8.1 Appendix 1: Classification of a Lease



8.2 APPENDIX 2: ACCOUNTING FOR A FINANCE LEASE BY A LESSEE



8.3 APPENDIX 3: ACCOUNTING FOR A FINANCE LEASE BY A LESSOR



9. EXAMPLES

EXAMPLE 1: ACCOUNTING FOR A FINANCE LEASE BY A LESSEE

The Ministry of Health enters into an agreement with Company ABC Ltd for the provision of a **specific and specialized medical equipment**, in return of an annual rental installment of €20.000, payable in arrears and the interest rate implicit for the lease is 10%. The agreement will be valid for 10 years and the Ministry of Health has the right to extend the lease for another 2 years. The medical equipment's economic life is 13 years. The Ministry of Health is responsible for the repairs and maintenance expenses during these years. The purchasing price (Fair Value) of the medical equipment is €180.000 and the carrying amount of the medical equipment in the records of Company ABC Ltd is €165.000. The unguaranteed residual value of the medical equipment is €5.000.

Question 1: Is it a finance or an operating lease?

Question 2: What is the Present Value of the minimum lease payments?

Question 3: How will the asset be presented in the financial statements of the Ministry of Health?

Answer 1: The lease between the Ministry of Health and the Company ABC Ltd is a finance lease. The indicators which lead to the solution are:

- The specificity and specialization of the medical equipment
- The right to continue with the lease for another 2 years
- The lease duration is for the major part of the medical equipment's life (no clear cut threshold but BEST Practices more than 75% of the asset's economic life)
- The repairs and maintenance expenses indicate that the Ministry of Health is in substance the owner of the medical equipment.

Answer 2: The Present Value of the medical equipment is €122.891,34, being calculated as follows:

$$PV = pmt \times \frac{1}{(1+r)^n}$$

	Payments	Discount Factor 10%	Present Value
Payment 1	20.000,00	0,909091	18.181,81818
Payment 2	20.000,00	0,826446	16.528,92562
Payment 3	20.000,00	0,751315	15.026,29602
Payment 4	20.000,00	0,683013	13.660,26911
Payment 5	20.000,00	0,620921	12.418,42646
Payment 6	20.000,00	0,564474	11.289,47860
Payment 7	20.000,00	0,513158	10.263,16236
Payment 8	20.000,00	0,466507	9.330,14760
Payment 9	20.000,00	0,424098	8.481,95237
Payment 10	20.000,00	0,385543	7.710,86579
	200.000,00	**P.V.**	**122.891,34211**

Answer 3: The Ministry of Health will present in the statement of financial position the following amounts:

Dr. Plant and Machinery (leased assets) €122.891,34
Cr. Finance Lease Obligations €122.891,34

The purchase price of the medical equipment is higher than the Present Value of the minimum lease payment therefore the Ministry of Health will recognise the lowest amount.

The difference between the total amount of payments (€200.000) and the Present Value of the minimum lease payment (€122.891,34) is the finance charge (€200.000-€122891,34 = 77.108,66) which will be allocated to the lease periods evenly. The following amortization table splits the lease payments into a finance charge and a reduction of the (outstanding) liability.

	Payment	Interest (Rate 10%)	Capital (finance lease obligation)	Balance
1/1/20x1				122.891,34
Payment 1	20.000,00	12.289,13	7.710,87	115.180,48
Payment 2	20.000,00	11.518,05	8.481,95	106.698,52
Payment 3	20.000,00	10.669,85	9.330,15	97.368,38
Payment 4	20.000,00	9.736,84	10.263,16	87.105,21
Payment 5	20.000,00	8.710,52	11.289,48	75.815,74
Payment 6	20.000,00	7.581,57	12.418,43	63.397,31
Payment 7	20.000,00	6.339,73	13.660,27	49.737,04
Payment 8	20.000,00	4.973,70	15.026,30	34.710,74
Payment 9	20.000,00	3.471,07	16.528,93	18.181,82
Payment 10	20.000,00	1.818,18	18.181,82	0,00
	200.000,00	77.108,66	122.891,34	

The accounting treatment for each payment will be as follows:

Dr. Statement of financial performance – Finance charge €12.289,13
Dr. Statement of financial position – Finance lease obligation € 7.710,87
Cr. Statement of financial position – Cash €20.000,00

Additionally, the medical equipment is subject to depreciation over the lease term.

Dr. Statement of financial performance – Depreciation charge €12.289,13
Cr. Statement of financial position – Accumulated depreciation €12.289,13

In cases were the lease agreement provides the right to transfer ownership of the medical equipment, then the Accounting Policy on Property, Plant and Equipment shall be followed.

EXAMPLE 2: ACCOUNTING FOR A FINANCE LEASE BY A LESSOR

Question: Assume that in the above example the lessor is the Ministry of Health and the lessee is the Company ABC Ltd. Demonstrate the accounting treatment by the lessor on the above example.

Answer: The lessor shall derecognise the medical equipment and recognise a Net Investment in the asset in the statement of Financial Position.

The Net Investment in the lease shall be:

Net Investment = Gross Investment – Unearned Income

	Payment	Interest 10%	Capital (finance lease obligation)	Balance
1/1/20x1				122.891,34
Payment 1	20.000,00	12.289,13	7.710,87	115.180,48
Payment 2	20.000,00	11.518,05	8.481,95	106.698,52
Payment 3	20.000,00	10.669,85	9.330,15	97.368,38
Payment 4	20.000,00	9.736,84	10.263,16	87.105,21
Payment 5	20.000,00	8.710,52	11.289,48	75.815,74
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Payment 9	20.000,00	3.471,07	16.528,93	18.181,82
Payment 10	20.000,00	1.818,18	18.181,82	0,00
	200.000,00	**77.108,66**	122.891,34	
Unguaranteed residual value	5.000,00	0,385543289	1927,72	
Net Investment in the lease			**€124.819,06**	

The Gross Investment in the lease is €20.000 * 10 installments = €200.000

The Unearned finance income is the total interest to be received = €77.108,66

The accounting treatment for the first year's payment will be as follows:

Dr. Statement of financial position – Net Investment in the lease	€124.819,06	
Dr. Statement of financial performance – Loss on derecognition	€40.180,94	
Cr. Statement of financial position – Plant and Machinery		€165.000

EXAMPLE 3: ACCOUNTING FOR OPERATING LEASE BY A LESSEE

The Ministry of Interior enters into a lease agreement on 01/01/2016, with a private owner to lease a land and building for 10 years. The expected future economic life of the building is 30 years and land has an indefinite economic life. The private owner has the obligation to repair the building over the lease term. The lease agreement ceased at the end of the lease term, no renewal option.

Question 1: Is it a Finance or an Operating lease?

Answer 1: The lease shall be classified as an operating lease. The indicators which lead to that conclusion are:

- The risks and rewards of ownership remain with the private owner on both land and building element, NO renewal option.
- The lease is only for 10 years out of the 30 years life of the building and the indefinite life of the land element.
- The private owner has the responsibility to repair the building over the lease term.

EXAMPLE 4: ACCOUNTING FOR OPERATING LEASE BY A LESSEE

The Ministry of Transport leased transport equipment from a third party, for the period of 3 years, commencing 01/01/2016. The expected useful economic life of the equipment was 10 years, and the third party is responsible for maintaining the transport equipment to its original condition. The two parties agreed to allow the usage of the equipment in the period between 01/01/2016 and 30/06/2016 without the payment of any rental. The lease rentals of €9.000 were payable six monthly in arrears, with the first payment falling due on 31 December 2016.

Question 1: How should the lease be accounted for in the financial statements of the Ministry of Transport?

Answer 1: The lease shall be classified as an operating lease because,

- The lease period is not for the major part of the equipment's life
- The third party has the responsibility to maintain the equipment to its original condition

Therefore, the lease expense should be recognised on a straight line basis; for the period of 3 years is €45.000 (€9.000*5 installments) and the lease charge for each period is €15.000 (€45.000/3 years). The difference between the lease charge and the rental payment will be shown either as a liability or as an asset. In our case the difference of the actual amount paid on 31 December 2016 and lease charge for the first year will be shown as a liability in the Statement of Financial Position of the Ministry of Transport (€9.000-€15.000 = €6.000).

The accounting treatment for the first year's payment will be as follows:

Dr. Statement of financial performance – Lease Expense	€15.000	
Cr. Statement of financial position – Operating lease liability		€6.000
Cr. Statement of financial position – Cash		€9.000

The accounting treatment for the next 2 years will be as follows:

Dr. Statement of financial performance – Lease Expense	€15.000	
Dr. Statement of financial position – Operating lease liability	€ 3.000	
Cr. Statement of financial position – Cash		€18.000

EXAMPLE 5: ACCOUNTING FOR OPERATING LEASE BY A LESSOR

The Ministry of Transport agreed to lease out transport equipment to a third party, for a period of 3 years. The total lease amount was €45.000 payable in advance at the commencement of the lease, on 01/01/2016. The transport equipment has a useful life of 10 years and the cost of the equipment is €100.000. Depreciation is charged on a straight line basis. The Ministry of Transport paid €1.500 per annum for repairing the transport equipment, according to the lease agreement's provisions.

Question1: How should the lease be accounted for in the financial statements of the Ministry of Transport?

Answer 1: Undoubtedly, the lease shall be classified as an operating lease, because:

- The lease period is not for the major part of the equipment's life
- The Ministry of Transport has the responsibility to repair the equipment.

The Ministry of Transport shall record the lease rental income equally over the life of the lease term despite the fact that the payment was received in full at the commencement of the lease, therefore it would record the following transactions in its books of accounts:

Dr. Statement of financial position – Cash	€45.000	
Cr. Statement of financial position – Unearned lease rental revenue		€30.000
Cr. Statement of financial performance – Lease rental revenue		€15.000

Additionally, the lessor shall record a depreciation charge regarding the equipment.

Dr. Statement of financial performance – Depreciation	€10.000	
Cr. Statement of financial position – Accum. Depreciation		€10.000