State Accounting Office of Georgia
Fiscal Leadership for Georgia

Statewide Accounting Directive

Subject File Reference: AD_201002_Lease Reporting	**Effective Date:** 06/21/2010 **Revision Date:** 03/11/2011

Definition of Lease Term and Leases Associated with Copier Machines/Postage Meters

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Event Description:
The State Accounting Office has purchased a lease accounting software package to improve processes and controls over lease accounting and financial reporting. As a result of this software implementation, questions have arisen regarding the definition of lease term for financial reporting purposes. Accordingly, there is a need to provide additional accounting directions for lease reporting. The purpose of this Accounting Directive is to (1) clarify the definition of "lease term" and (2) provide organizations in the State of Georgia reporting entity (State organizations) with guidance as to accounting for leases on copier machines/postage meters.

Authority:

- OCGA 50-5B-3, *Duties of the State Accounting Officer*
- FASB Statement No. 13, *Accounting for Leases* (Statement No. 13)
- National Council on Governmental Accounting Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments* – paragraphs 18-21

Background and Discussion:

Definition of Lease Term

For GAAP financial reporting purposes, a "lease" has been defined as an agreement that involves payments extending for a period greater than twelve months (one year). Agreements of one year or less are considered rental payments, and are not subject to reporting and disclosures required of leases. In order to ensure consistency in the determination of the duration of an agreement for purposes of classifying such agreements as either lease or rental, clarification is provided below.

In applying the criteria of Statement No. 13 to lease agreements of state governments, legal restrictions must be considered. Because of the legal restriction included in the State of Georgia Constitution that prohibits State organizations from entering into obligations beyond the current fiscal year, lease agreements typically contain a fiscal funding or cancellation clause that permits the State organization to terminate the agreement on an annual basis if funds are not appropriated to make required payments.

Paragraph 5(f) of Statement No. 13 requires that a cancelable lease, such as a lease containing a fiscal funding clause, be evaluated to determine whether the uncertainty of possible lease cancellation is a *remote* contingency. That paragraph states that "a lease which is cancelable (i) only upon occurrence of some remote contingency…shall be considered 'noncancelable' for purposes of this definition" of lease term.

The economic substance of most lease agreements with fiscal funding or cancellation clauses is that they are essentially long-term contracts. The potential for cancellation of most government lease agreements is remote; that is, routine cancellations of such agreements would discourage potential lessors from entering into such lease agreements with the State. In substance, notwithstanding the fiscal funding clause, the economic substance of lease agreements should be considered instead of the legal form. For financial reporting purposes, the definition of lease term as provided in this directive overrides the legal form of the contract term.

Fiscal funding or cancellation clauses also should not prohibit lease agreements from being capitalized. In general, a lease subject to cancellation cannot be capitalized; however, if the lease is subject to cancellation based on the occurrence of a remote event, the lease may be capitalized if one of the four capitalization criteria is met. Generally, the likelihood of exercising a fiscal funding clause in the State is remote. Likewise, even though many lease agreements include annual renewal clauses, the likelihood of not renewing a lease is remote.

Therefore, when determining the term of a lease for financial reporting purposes, the fact that the lease agreement includes fiscal funding, cancellation or renewal clauses is not to be used as the rationale for limiting the lease term to the initial term. State organizations should consider the term of leases to be the same as the initial term plus the number of any renewal periods.

For example: A State organization signs a lease agreement for a building. The lease agreement states that the tenant has the option of renewing or extending the lease on a year-to-year basis for 20 consecutive years (which includes the initial year). Annually, the State organization signs a lease agreement for that fiscal year. Therefore, even though the lease agreement is renewed every year, the lease term is 20 years. The probability of the lease being cancelled is *remote*, and the *intent* of the State organization is to renew the lease annually over the 20 year period. **The intent of the lease term overrides the legal form of the lease term for financial reporting purposes.**

This definition of lease term applies both to operating leases and to capital leases. Therefore, the definition must be considered both when analyzing the four capitalization criteria and when reporting future lease commitments.

Leases for copier machines/postage meters

Beginning with fiscal year 2010, State organizations should consider leases for copier machines/postage meters used for administrative or operational purposes to be operating leases rather than capital leases (even if at least one of the four capital lease criteria are met). If the copier is primarily used for external production purposes (e.g., used in a mass production capacity for making copies for other State organizations and/or external customers rather than used basically for internal administrative purposes), then the lease can be classified as a capital lease if it meets at least one of the capital lease criteria. Additional guidance will be communicated through the year-end reporting package instructions.

Related Policies and Procedures:
State of Georgia Accounting Procedures Manual, Section 3, *Capital Leases/Installment Purchases Payable*

Contact Information:
Lease classification questions should be sent to SAO_Reporting@sao.ga.gov or Sharon Hill at shill@sao.ga.gov.