State Accounting Office

Statewide Accounting Policy & Procedure

Accounting Manual Reference: Section: Leases Sub-section: Lessee Accounting	Effective Date: 07/01/2015 Revision Date: 07/01/2015

Index:

Authority:

- GASB Statement No. 62 – *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (Leases section, paragraphs 211–271)
- GASB Statement No. 66 – *Technical Corrections – 2012 – an amendment of GASB Statements No. 10 and No. 62* (paragraphs 24-26)
- GASB Statement No. 13 – *Accounting for Operating Leases with Scheduled Rent Increases*
- National Council on Governmental Accounting Statement 5 – *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*
- GASB Codification Section L20 – *Leases*
- Georgia Constitution, Article III, Section VI, Paragraph VI – *Gratuities*
- OCGA 12-3-113 – *Duties and powers of department as to system; requirements as to title to land traversed by system* (applies to the Department of Natural Resources)
- OCGA 50-16-7 – *Improvement of real estate held by state in fee simple with reversionary interest in federal government or under long-term federal license*
- SAO Accounting Policy Manual, Capital Assets: *Capital Assets – General*

Applicability:

This accounting policy applies to all organizations included in the State of Georgia reporting entity. Refer to the *Management Responsibilities* policy for a summary of general financial reporting responsibilities.

Policy Summary:

This policy provides guidance to lessees for the most common State leasing transactions. More comprehensive guidance on accounting for and reporting lease transactions under generally accepted accounting principles (GAAP) is provided in the GASB Codification Section L20, *Leases*.

A lease exists when payments for the right to use property or equipment extend over a period greater than twelve months (one year). Leases can be classified as capital or operating.

A lease should be reported as a capital lease if all 3 criteria below are met:

- It meets any of the four capital lease criteria described in the Policy Requirements section described below, and
- The exercise of a fiscal funding or cancellation clause (defined in the Policy Requirements section, below), if any, is determined to be remote (i.e., the lease is deemed non-cancelable), and
- The value of the leased item equals or exceeds the capitalization threshold for the asset classification that most closely relates to the leased asset.

Leases that are considered cancelable and those which do not meet any of the four capital lease criteria should be accounted for as operating leases. Normally, activity for operating leases is charged to expenditure/expense over the lease term as it becomes payable. For statewide reporting purposes, payments related to agreements of one year or less are considered rental payments and are not subject to the reporting and disclosures required of leases.

SAO uses a lease accounting software package to manage the lease reporting process for State organizations that are not subject to external CPA audits, thereby standardizing control over lease accounting and financial reporting for these organizations. This policy includes guidance regarding the roles of fiscal funding, cancelation and renewal clauses in the reporting of State leases to further ensure consistency. The policy also provides specific guidance on classifying leases for copier machines and postage meters as either operating or capital leases.

Policy Requirements:

Classification as Capital or Operating Lease

A lease that transfers substantially all the benefits and risks inherent to ownership of the property or equipment should be accounted for as a capital lease by the lessee. The recording of a capital lease reflects the acquisition of a capital asset and the incurrence of a long-term liability. All other leases should be classified as operating leases.

If a lease meets one or more of the following four criteria at inception, then it should be classified, accounted for and reported as a capital lease:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option, i.e., the difference between the option price and the expected fair value. When the option becomes exercisable, it is large enough to make exercise of the option reasonably assured.
3. The lease term is equal to 75% or more of the estimated economic life of the leased property. The exception to this rule occurs when the beginning of the lease term falls with the last 25% of the total estimated economic life of the leased property, including earlier years of use. If this exception exists, this criterion is not used for purposes of classifying the lease.
4. The present value at the beginning of the lease term of the minimum lease payments (excluding that portion of the payments that represents executory costs such as insurance and maintenance to be paid by the lessor, including any gain thereon) equals or exceeds 90% of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit by the lessor that is expected to be realized. The exception to this rule occurs when the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property, including earlier years of use. The lessee must use its own incremental borrowing rate as the discount rate when calculating the present value unless the lessor's implicit

rate of return is stated in the lease agreement and the lessor's rate of return is less than the lessee's borrowing rate.

Criterion 1or 2 must be met for capital lease purchases of land. Criteria 3 and 4 do not apply to capital leases of land.

Fiscal Funding or Cancellation Clause

A lease may contain a fiscal funding or cancellation clause indicating that the lease is cancelable (can be terminated without penalty) if the appropriating body does not allocate the necessary funds to make the required lease payments for the next budget period. The role of fiscal funding or cancellation clauses in State leases is discussed, at length, in the General Accounting Procedures below.

Leases within the Reporting Entity

If a State organization is part of the primary government for financial reporting purposes, and enters into a lease agreement where the lessor entity (public authority, department, agency, division, etc.) is also part of the primary government, then the lease should not be reported as either an operating or capital lease. The payments for these agreements should be considered ordinary operating expenditures/expenses by the lessee organization. For example, agreements between Georgia Building Authority (GBA) and other organizations included in the State's primary government should not be reported as leases in the statewide CAFR.

If any State organization enters into a lease agreement where the lessor is either a) a discretely presented component unit or b) a public organization that is ***not*** part of the governmental unit entity for financial reporting purposes, then the lease should be treated in the same manner as any other lease agreement of the State

A current list of organizations within the primary government can be found using the following link: http://sao.georgia.gov/reporting-structure-and-chart-accounts

Leasehold Improvements

A leasehold improvement is an improvement made to a leased building by a State organization that has the right to use the leasehold improvement over the term of the lease. This improvement will revert back to the lessor at the expiration of the lease term. Leasehold improvements should not include normal maintenance and repairs.

Leasehold improvements should be capitalized if:

- The lessee pays for the improvement.
- The leasehold improvement is significant (e.g., it meets the capitalization threshold for the asset class),durable and will last for at least one year.
- The improvement reverts to the lessor at the end of the lease.

The leasehold improvement should be depreciated over the shorter of:

- The remaining lease term or
- The estimated useful life of the improvement.

Leasehold improvements do not have a residual value. Leasehold improvements made in lieu of rent should be expensed in the period incurred.

Based on State law and several Attorney General Opinions, State organizations cannot use State funds to make a permanent leasehold improvement unless the leased property falls into any of the categories below:

- Owned by the State, or
- Held by the State in fee simple or under a quitclaim deed with a reversionary interest in the federal government, or
- Held by the State under a long-term federal license with a reversionary interest in the federal government.

The reversion of a permanent leasehold improvement constructed with State funds to an entity other than the State or the federal government is considered a gratuity which is prohibited by the Georgia Constitution.

Lease Modifications

Prior to the expiration of the lease term there may be a change in the provisions of the lease, renewal or extension of an existing lease, or termination of a lease. State organizations should review and apply the provisions of GASB Codification Section L20 when these situations occur.

Real Estate

Leases involving real estate are divided into the following categories:

- Leases involving land only
- Leases involving land and buildings
- Leases involving equipment as well as land and/or buildings
- Leases involving only part of a building

Leases involving real estate require additional evaluation. The provisions of GASB Codification Section L20 should be applied when classifying a real estate lease as either capital or operating.

Subleases or Sale-Leaseback Transactions

Subleases or leases involving the sale of property by the owner and a lease of the property back to the seller require additional evaluation. The provisions of GASB Codification Section L20 should be applied when accounting for and reporting these transactions.

Operating Leases with Scheduled Rent Increases

State organizations may enter as lessees into operating leases with scheduled rent increases (escalation clauses). These scheduled rent increases are fixed by provisions in the lease. For operating leases with scheduled rent increases, the lease rentals must be accrued on a systematic and rational basis. The rental schedule is considered systematic and rational if the rent increases reflect economic factors related to the leased property including, anticipated cost increases or anticipated increases in property values. In these situations, operating lease payments are due as they become payable. However, if no economic justification can be offered (for example, if a “rent holiday” is provided), then rental costs should be recognized on a straight line basis over the term of the lease or may be measured based on the estimated fair value of the rental.

Recognition and Measurement

Valuation of the Capital Asset and the Lease Obligation

Present Value of Minimum Lease Payments or Fair Value:
At the inception of a capital lease, the amounts recorded for the capital asset and for the lease obligation must be the same. The amounts to be recorded equal ***the lower of***:

- The present value of the minimum lease payments, excluding that portion of the payments representing executory costs (such as, insurance and maintenance to be paid by the lessor) including any gain thereon or
- The fair value of the leased property at the inception of the lease.

When calculating the present value of minimum lease payments, if the executory costs cannot be determined from the provisions of the lease, an estimate should be made. Additionally, the present value should be calculated using the ***lower*** of the lessee's incremental borrowing rate or the lessor's interest rate implicit in the lease, if known.

Certain costs should be included and excluded when calculating the present value of the minimum lease payments. These costs are shown below.

- Include:
  - Minimum lease payments over the lease term
  - Guaranteed residual value at the end of the term (guaranteed the lessor by the lessee or third party)
  - Any payment required of the lessee for failure to extend or renew the lease
  - Bargain purchase option

- Exclude:
  - Executory costs
  - Contingent rentals
  - Maintenance agreements – If the lease agreement specifically states a monetary amount that is included in the lease payments for maintenance costs, then those maintenance costs should be excluded from the calculation of the present value of the minimum lease payments.

Fair Value generally reflects the price for which the leased item could be sold in an arm's length transaction between unrelated parties at the inception of the lease. For example, the fair value at the inception of a lease could be its normal selling price, reflecting any applicable volume or trade discounts. Fair value should be determined based on prevailing market conditions, which may indicate that the fair value is less than the normal selling price or even less than the cost of the property.

An operating lease does not result in the acquisition of an asset nor entry into a long-term obligation. Therefore neither an asset nor a liability is recorded at the inception of an operating lease.

Depreciation of the Leased Capital Asset
Capital assets acquired through capital leases, other than land, are depreciated as follows depending on the criteria under which the lease qualified as a capital lease:

If the provisions of a capital lease contain either of the following features, the capital asset acquired through the lease should be depreciated using the State's normal depreciation method over the economic life established for the related capital asset class in the *Capital Assets - General* policy:

- The lease transfers ownership of the property to the lessee by the end of the lease term, or
- The lease contains a bargain purchase option.

If the provisions of the capital lease do not contain either of the above features, the capital asset acquired through the lease should be depreciated using the State's normal depreciation method, with the asset life limited to the lease term (i.e., the lesser of the economic life established in the capital asset policy or the lease term).

As with land that is purchased, land acquired through a capital lease is not depreciated.

<u>Amortization and Allocation of Capital Lease Obligations</u>
An amortization schedule is required for any lease classified as a capital lease. The schedule allocates each minimum lease payment during the lease term between a reduction of the principal and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation. This allocation process is referred to as the interest method. Reporting of this schedule is described in the Disclosure Requirements below.

<u>Recognition of Expenditure/Expense for Operating Leases</u>
The lease payments for operating leases are recognized as expenditures/expenses throughout the lease term as amounts become payable. No amortization schedule or allocation between lease principal and interest expense is required to be reported. However, future minimum rental payments are required to be reported as described in the Disclosure Requirements below.

Basis of Accounting
Organizations included in the State reporting entity are required to maintain their accounting records in a manner that provides for the preparation of both GAAP financial statements and budgetary statements. Day-to-day operations may be accounted for using a budgetary/statutory basis of accounting, which is also used for preparing the year-end BCR. The primary statements in the year-end CAFR, however, are prepared using different bases of accounting, the GAAP bases: modified accrual and accrual.

<u>Statutory</u>
Periodic payments on both capital and operating leases are recognized as expenditures on the statutory basis of accounting. Payments for operating leases are recorded as rent expenditures, whereas payments for capital leases should be recorded as capital lease principal and interest expenditures.

<u>GAAP Modified Accrual</u>
Governmental funds recognize periodic payments on capital and operating leases as expenditures in the period incurred. State organizations reported as governmental funds should also record other financing sources and capital outlay expenditures for the net present value of the minimum lease payments. This applies in the initial year of the lease term only. Principal amounts of lease payments due within 12 months should be recorded as a current liability.

<u>Accrual</u>
Proprietary funds, fiduciary funds, component units using the accrual basis, and the government-wide financial statements should report capital assets as well as long and short-term payables on the statement of net position. Therefore, for capital leases, a capital asset and lease obligation should be recorded at inception of the lease and periodic lease payments should be recorded as interest expense and a reduction

to the capital lease obligation. Additionally, depreciation expense related to the leased capital asset should be recorded.

General Accounting Procedures:

The following procedures are used by organizations in the State of Georgia reporting entity to meet the requirements for statutory and GAAP reporting purposes.

Identifying Transactions

Leases may be executed through contracts or purchase orders. Even when executed through a purchase order, State organizations should apply the GAAP lease criteria for financial reporting purposes. While a formal lease document may not exist, the obligation for a lease is created when the purchase order is prepared. The purchase order is a payment mechanism, while the narrative explanation within the purchase order creates the contractual lease agreement.

Each agreement must be evaluated to determine whether the transaction should be treated as a capital lease, operating lease, or rental agreement. SAO uses a lease accounting software package to manage the lease reporting process for State organizations that are not subject to external CPA audits, thereby standardizing control over lease accounting and financial reporting. These organizations should be able to reconcile current year information provided to SAO for lease payments to lease payments recorded in the general ledger. State organizations subject to external CPA audited organizations should ensure that controls are in place at their locations to ensure compliance with this policy. The following guidance also applies when identifying and evaluating transactions.

Space Rental

Leases involving space rental are evaluated in the same manner as any other lease agreement.

Limited Use Agreements

Lease agreements for less than one year or for a certain amount of days in each month during the year are considered rentals and are not subject to the lease requirements. Additional discussion is provided in the Determination of the Lease Term section below.

Leases below the Capitalization Threshold

If a lease meets one or more of the capital lease criteria but the calculated acquisition cost of the asset acquired is below the standard capitalization threshold established by the State for major capital asset classes, then the lease is considered an operating lease.

Determination of the Lease Term

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

Part of determining a lease term (in applying the criteria of GASB Codification – Section L20) requires that applicable legal restrictions be considered. Legal restrictions applicable to State organizations, which are included in the State Constitution, prohibit State organizations from entering into obligations beyond the current fiscal year. In order to comply with the Constitution, lease agreements typically contain a fiscal funding or cancellation clause that permits a State organization to terminate an agreement on an annual basis if funds are not appropriated to make required payments.

The likelihood of exercising a fiscal funding clause in the State is considered to be a **remote** contingency. The reason the potential for cancellation of most government lease agreements is considered remote is that routine cancellation of such agreements would discourage potential lessors from entering into lease agreements with the State. Therefore, the economic substance of most agreements with fiscal funding clauses or cancellation clauses is that they are essentially long-term contracts and therefore, leases. For financial reporting purposes, the economic substance for determination of an agreement term, as provided in this policy, overrides the legal form of a stated contract term.

If necessary, SAO advises that a lease containing a fiscal funding clause be evaluated to determine whether the uncertainty of possible lease cancellation is other than a remote contingency. A lease which is cancelable only upon occurrence of some remote contingency shall be considered ‘noncancelable’ for purposes of this definition of lease term. Documentation must be maintained and made available for auditor review for any evaluation that determines that exercise of a fiscal funding clause is **not** remote.

Fiscal funding or cancellation clauses also should not prohibit lease agreements from being categorized as a capital lease, as opposed to an operating lease. In general, a lease subject to cancellation cannot be considered a capital lease, unless the lease is subject to cancellation based on the occurrence of a remote event, in which case, the lease may be capitalized if one of the four capitalization criteria is met.

Many leases entered into by State organizations also include renewal clauses whereby a lease has a stated term and may be renewed for additional terms. Just as the likelihood of exercising a fiscal funding clause in the State is remote, likewise, the likelihood of not renewing a lease is also considered to be remote. Leases which include renewal clauses can be categorized as capital leases. Documentation must be maintained if a State organization contends at the inception of the lease, that annual renewal over the negotiated term is not expected and that a lease with a renewal clause is to be categorized as an operating lease (or a rental agreement).

In summary, 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, thus categorizing an agreement as a rental agreement rather than as a lease. ***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 to renew over the lease term overrides the legal form of the lease term for financial reporting purposes***.

<u>Leases for Copier Machines and Postage Meters</u>
State organizations should consider leases for copier machines and 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 <u>external</u> 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 should be classified as a capital lease if it meets at least one of the capital lease criteria.

<u>Reflecting the Capital Asset Associated with Capital Leases</u>

For State organizations that are not subject to external CPA audits, leased assets are not required to be entered into the asset management module of the statewide financial system. The values of these assets for CAFR reporting purposes, including depreciation information, are derived from information provided by reporting organizations that is input into the lease accounting system managed by SAO. If such an organization chooses to use the asset management module for inventory tracking purposes of capital lease acquired assets, then the profile ID for these leased capital assets should be set to track the assets as small value assets with "zero-dollar" values. The required entries to record these assets are prepared by SAO for reporting on a statewide basis during the annual CAFR process.

For State organizations that are subject to external CPA audits, appropriate records should be maintained to ensure that applicable expenditures, other financing sources, asset values and depreciation for capital leased items can be reported properly under each basis of accounting in compliance with this policy.

Reflecting the Capital Lease Obligation Associated with Capital Leases

For State organizations that are not subject to external CPA audits, the valuation of the obligation at lease inception and the subsequent allocation of minimum lease payments between interest expense and reduction of principal are derived from information provided by reporting organizations that is input into the lease accounting system managed by SAO. The required entries to record these capital lease obligations and related interest are prepared by SAO for reporting on a statewide basis during the annual CAFR process.

For State organizations that are subject to external CPA audits, appropriate records should be maintained to ensure that the interest, principal reduction and long-term lease obligation for capital leases can be reported properly under the accrual basis of accounting in compliance with this policy.

Accounting Transactions and Journal Entries

The journal entry examples provided in this section are based on accounts listed in the State Chart of Accounts (SCOA) which is posted on the reporting structure page of the SAO website. The link to the SCOA is SAO.Georgia.gov >Statewide Reporting > Reporting Structure and Chart of Accounts. As stated above, State organizations that are subject to external CPA audits are responsible for properly classifying leases as operating or capital and for preparing all entries needed for reporting under each basis of accounting that applies to the organization (statutory, modified accrual and/or accrual). Organizations that are not subject to external CPA audits are responsible for recording lease payments under the statutory basis of accounting and for supplying information to SAO as described in the Year-end Accounting Procedures section below. SAO classifies the leases and prepares journal entries to report under the modified accrual and accrual bases of accounting for organizations that are not subject to external CPA audits.

Operating Lease Example (Statutory Basis)

Assume that equipment is leased for a three year lease term and that the lease does not meet the criteria for treatment as a capital lease.

To record the lease payments in each year of the lease term (assuming that no encumbrance was recorded):

Debit	$	10,300	Rent Expenditure (Various e.g., 619xxx, 648xxx, 819xxx)
Credit	$	10,300	Cash (10xxxx) or Accounts Payable (200xxx) as appropriate

This entry reduces fund balance. No additional entries are required under the modified accrual or accrual basis of accounting.

Capital Lease Example

Assume that equipment is leased for a three year lease term and the lease meets the criteria for treatment as a capital lease. Also, assume that the following payment and amortization schedule applies.

Amortization Schedule	Principal	2% Annual Interest*	Total Payment	Outstanding Principal Balance
Lease Inception				$ 30,000
Year 1	$ 9,800	$ 500	$ 10,300	20,200
Year 2	10,000	300	10,300	10,200
Year 3	10,200	100	10,300	-
	$ 30,000	$ 900	$ 30,900	
Present Value of Minimum Lease Payments at 2%			$ 30,000	

*Organizations that complete the "Lease Agreement Data" form as discussed in Year-end Accounting Procedures below may record the entire payment as a debit to Rent Expenditure. The calculation and recording of the interest portion of the payment is not necessary.

Statutory Basis Journal Entry

To record the lease payments for the first year of the lease term (assumes no encumbrance was recorded):

Debit	$	9,800	Capital Lease – Principal Payments (713xxx)
Debit	$	500	Capital Lease – Interest Payments (716xxx)
Credit	$	10,300	Cash (10xxxx) or Accounts Payable (200xxx) as appropriate

This entry reduces fund balance. A similar entry is recorded each year of the lease term, however, the split between principal and interest changes each year, as demonstrated in the table above.

Modified Accrual Basis Journal Entry

To record the acquisition cost of the asset/value of the lease as determined according to the Valuation of the Capital Asset and the Lease Obligation section above. This entry is recorded in ***only the initial year*** of the lease term and presents the activity as a capital outlay expenditure:

Debit	$	30,000	Capital Outlay Expenditure (Various accounts in the 72xxxx series)
Credit	$	30,000	Other Financing Sources – Capital Leases (476xxx)

This entry does not affect fund balance.

To record the entry in the second year of the lease:

Debit	$	10,000	Capital Lease – Principal Payments (713xxx)
Debit	$	300	Capital Lease – Interest Payments (716xxx)
Credit	$	10,300	Cash (10xxxx) or Accounts Payable (200xxx) as appropriate

Accrual Basis Journal Entries
The following entries are needed to adjust modified accrual basis records to the accrual basis of accounting. Amounts reflect activity for Year 1 based on the above amortization schedule.

To record the present value of minimum lease payments as a capital asset and to reflect a long-term liability for the capital lease obligation:

Debit	$	30,000	Capital Asset (Various accounts in the 17xxxx series)
Credit	$	30,000	Capital Lease Obligation – Noncurrent (286xxx)

To record depreciation expense related to the capital asset, assuming a three year useful life with no salvage value:

Debit	$	10,000	Depreciation Expense (740xxx)
Credit	$	10,000	Accumulated Depreciation (Various accounts in the 17xxxx series)

To reduce rent expense recorded under the statutory basis by the amount related to principal payments:

Debit	$	9,800	Capital Lease Obligation – Noncurrent (286xxx)
Credit	$	9,800	Capital Lease – Principal Payments (713xxx)

To reclassify the current portion of the capital lease obligation from noncurrent liabilities:

Debit	$	10,000	Capital Lease Obligation – Noncurrent (286xxx)
Credit	$	10,000	Capital Lease Obligation – Current (257xxx)

To reverse the entry made under the modified accrual basis since it does not apply to the accrual basis:

Debit	$	30,000	Other Financing Sources – Capital Leases (476xxx)
Credit	$	30,000	Capital Outlay Expenditure (Various accounts in the 72xxxx series)

This entry does not affect fund balance.

In subsequent years, additional entries are required to reinstate beginning balances for any capital leases that may have existed at the end of the prior year. Beginning balances for capital assets, accumulated depreciation, and capital lease obligations are reinstated with an offset to beginning net position.

To reinstate the Year 1 ending asset balances as the beginning balances for Year 2:

Debit	$	30,000	Capital Asset (Various accounts in the 17xxxx series)
Credit	$	10,000	Accumulated Depreciation (Various accounts in the 17xxxx series)
Credit	$	20,000	Adjustment to Net Position – July 1

To reinstate the Year 1 ending lease obligation balance as the beginning balance for Year 2 – Reflect combined current and noncurrent portions as noncurrent:

Debit	$	20,200	Adjustment to Net Position – July 1
Credit	$	20,200	Capital Lease Obligation – Noncurrent (286xxx)

Year-end Accounting Procedures

State organizations must coordinate with the SAO statewide accounting and reporting group to confirm that the appropriate journal entries are recorded to properly report leases under the modified accrual and accrual bases of accounting at year-end. All required information must be provided to SAO in accordance with the annual year-end reporting calendar. Organizations may provide their information either by completing the "Lease Agreement Data" form for year-end reporting or by providing independently audited financial statements that include required lease disclosures. Organizations providing independently audited financial statements should comply with this policy. The "Lease Agreement Data" form, with detailed instructions, is available for download from the Year-End Reporting page of the SAO website: (SAO.Georgia.gov > Statewide Reporting > Year-End Reporting).

Funds that operate on a statutory basis must convert their accounting activity to the modified accrual and/or accrual bases of accounting for the CAFR. Proprietary and fiduciary funds that do not operate on a statutory basis use the accrual basis of accounting throughout the year.

- Statutory Basis for Budgetary Compliance Reporting
  Periodic payments on both capital and operating leases are recognized as expenditures on the statutory basis of accounting. The expenditure is recognized at the earlier of the time the funds are encumbered (i.e., when purchase orders or other contractual obligations have been executed) or the time the rights under the lease have been received. Accruals are required at year-end for unencumbered lease periods that have lapsed but for which payments have not been processed through the accounts payable subsystem. A reclassification from encumbrance liability to accounts payable is required for any encumbered periods that have lapsed but for which payments have not yet been processed through the accounts payable subsystem by year-end.

- Converting to GAAP Modified Accrual Basis for CAFR Reporting
  Governmental funds recognize periodic payments on capital and operating leases as expenditures in the period incurred. Even though capital assets and long-term liabilities are not reported in fund financial statements under the modified accrual basis of accounting, entrance into a capital lease obligation is required to be reported as a capital outlay expenditure in governmental funds in the year of a capital lease's inception (i.e., as the acquisition of an asset). The following adjustments are required to convert from the statutory basis to the modified accrual basis of accounting:

  - For both operating and capital leases: Any ending encumbrance liability balance related to leases is eliminated, and beginning fund balance is increased by the prior year encumbrance liability related to leases. The offsetting changes in the encumbrance liability are recorded as expenditures to recognize the current year impact. If the net change in encumbrance liability decreased during the year, the adjustment results in an increase to expenditures, but if the net change in encumbrance liability increased from the prior year balance, the result is a decrease to expenditures.

  - For capital leases: As indicated above, although capital leases are not reported on governmental fund financial statements as capital assets or long-term debt, State organizations should record a transaction as though an asset were purchased outright, if the outlay meets the capitalization threshold for similar assets:

    - In the ***initial year*** of the capital lease, the lessee records both a "capital outlay" expenditure and an other financing source even though financial resources for the full lease value were not actually received or disbursed. This entry has a zero impact on fund balance.

- The amount initially recorded and reported as the capital outlay is the acquisition cost determined according to the Valuation of the Capital Asset and the Lease Obligation section, above.

- Converting to Accrual Basis for CAFR Reporting
  The State prepares government-wide financial statements in addition to fund financial statements. Government-wide financial statements include governmental and proprietary funds, as well as, component units. Governmental fund activity must be adjusted to the accrual basis of accounting for government-wide reporting purposes. Adjustments to the accrual basis are also required for other funds that operate on a statutory basis (certain proprietary and fiduciary funds or component units).

  - Capital leases that were initiated in the reporting year and were reported as capital outlay expenditures in governmental funds under the modified accrual basis of accounting must be reflected as capital assets rather than as expenditures. Related long-term liabilities for the capital lease obligations that were reported as other financing sources on the fund level must also be recognized in the same amounts that were initially recognized as capital assets.

  - Depreciation expense associated with the capital assets is recognized.

  - Payments made on capital leases during the year are reported as reductions to capital lease obligations rather than as expenditures.

  No adjustment is required to convert operating leases from the modified accrual basis to the accrual basis.

- Accrual Basis for Funds Not Reporting on a Statutory Basis
  Activity in proprietary and fiduciary funds and component units that do not operate on a statutory basis is reported throughout the year using the full accrual basis of accounting. These proprietary and fiduciary funds and component units report operating lease payments as expenditures when due. They report assets acquired under capital leases that meet the State's capitalization thresholds as capital assets and report the related capital leases in long-term liabilities in their fund financial statements.

  - In the initial year only, the lessee reports the purchase of a capital asset acquired through a capital lease as a capital asset, offset by capital leases payable. The amount initially recorded and reported as a capital asset should equal the acquisition cost determined according to the Valuation of the Capital Asset and the Lease Obligation section, above.

  - Depreciation expense associated with the capital assets is recognized.

  - Interest expense is recognized throughout the lease term and principal reductions to capital lease obligations are recorded as payments are made.

The State has component units in governmental, proprietary and fiduciary funds. Component unit reporting of capital and operating leases follows the basis of accounting appropriate for the fund type as described above.

Disclosure Requirements

The government-wide financial statements present information about the overall State. All governmental and proprietary (business-type) activities are included, but fiduciary activities are excluded. Component units in the governmental and proprietary funds are either blended in the government-wide financial statements or discretely presented. Component units in fiduciary funds are not reported in the government-wide financial statements.

GAAP requires the following disclosures for capital lease obligations:

- General description of the leasing arrangements.
- Gross amount of assets recorded under capital leases, presented by major asset classes.
- Total minimum future sublease rentals to be received.
- Total contingent rentals incurred.
- Accumulated amortization of leased assets and amortization expense (if not displayed on statements) or a statement that amortization is included as part of depreciation expense.
- Minimum future lease payments for each of the next five years and in five year increments thereafter, presenting a deduction for the amount of imputed interest to reduce the net minimum future lease payments to their present value. If the minimum lease payments presented include executory costs, then those executory costs should be deducted as a separate line item from the interest deduction.

GAAP requires the following disclosures for operating lease obligations:

- General description of leasing arrangements.
- Minimum future sublease rentals to be received (only for noncancelable subleases).
- Current year rental expense/expenditures (with separate amounts for minimum rentals, contingent rentals, and sublease rentals).
- Future minimum rental payments for each of the next five years and in five year increments thereafter (only for noncancelable leases of more than one year).

Additionally, the nature and extent of leasing transactions with related parties must be disclosed.

Definitions:

Bargain Purchase Option – A provision allowing the lessee the option to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Contingent Rentals – The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or pre-construction period should be excluded from contingent rentals.

Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, should be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of revenue or expense/expenditure as accruable.

Estimated Economic Life – The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

Executory Costs – Expenses incurred for items related to the lease agreement, such as insurance and maintenance to be paid by the lessor. Amounts paid in consideration for a guarantee by an unrelated third party are also executory costs.

Fair Value of the Leased Property – The price for which the property could be sold in an arm's-length transaction between willing parties, that is, other than in a forced or liquidation sale.

Inception of the Lease – The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment should be in writing, signed by the parties in interest to the transaction, and should specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

Incremental Borrowing Rate – The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term, the resources necessary to purchase the leased asset.

Interest Rate Implicit in the Lease – The discount rate that, when applied to (1) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together with any gain thereon, and (2) the unguaranteed residual value accruing to the benefit of the lessor, causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by and expected to be realized by the lessor. If an interest rate is explicitly stated in the lease agreement, that stated rate would be used to calculate the present value of the minimum lease payments.

Lease – An agreement between a lessor and a lessee that conveys to the lessee the right to use capital assets (land and/or depreciable assets) for a specified period of time that is greater than twelve months (one year) and for predetermined cash payments (rents).

Lease Term – As interpreted by the State for consistency purposes: The lease term is the initial term plus the number of any renewal periods, not treating a fiscal funding clause as a cancellation or term-limiting feature (because the likelihood of canceling or not renewing is remote).

This interpretation is based on GASB Statement No. 62 which includes the following in its definition of lease term: “The fixed noncancelable[131] term of the lease plus…all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured,… all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable…***A lease that is cancelable … only upon the occurrence of some remote contingency, …should be considered “noncancelable” for purposes of this definition***.” Statement No. 62 footnote 131 states: “See paragraphs 18 – 21 of NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, regarding fiscal funding and cancellation clauses.”

Penalty – Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's operations or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

Related Parties – This term encompasses the following parties and situations:

- A government's related organizations, joint ventures, and jointly governed organizations, as defined in GASB Statement No. 14, *The Financial Reporting Entity*, as amended;
- Elected and appointed officials of the government; its management; members of the immediate families of elected or appointed officials of the government and its management; and other parties with which the government may deal if one party can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- A party that can significantly influence the management or operating policies of the transacting parties (for example, through imposition of will as discussed in Statement 14, as amended) or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Residual Value (RV) of Leased Property –

- Estimated RV is the estimated fair value of the leased property at the end of the lease term.
- Guaranteed RV is the amount of the estimated RV that is (a) the certain or determinable amount at which the lessor has the right to require the lessee to purchase the property or (b) the amount the lessee or third party guarantor guarantees the lessor will realize. A guarantee by a third party related to the lessee should be considered a lessee guarantee. If the guarantor is related to the lessor, the residual value should be considered unguaranteed.
- Unguaranteed RV is the estimated RV exclusive of any portion guaranteed by the lessee or by a third party unrelated to the lessor.