

State of Georgia Leases Reporting Guidance

Accounting Directive AD 201002_ Lease Accounting was issued June 21, 2010. To the extent the guidance below conflicts with this accounting directive, the accounting directive takes precedence. The accounting directive is posted on the SAO website at the following link:

http://sao.georgia.gov/00/channel_createdate/0,2095,39779022_138756145,00.html

General

Objective

Account for the State's leases in conformity with General Accepted Accounting Principles (GAAP).

Compliance

All agencies will comply with the criteria set forth in this document and other authoritative resources when analyzing lease agreements to determine if a lease has met all the criteria for a capital lease before a capital lease, asset and liability, is recorded in the accounting records and reported in the financial statements. In addition, all agencies are required to annually report accurate, complete and timely lease information to the State Accounting Office (SAO).

Definition

A lease is defined as an agreement between a lessor (vendor) and a lessee (State/agency) that conveys the lessee the right to use property or equipment for a specified period of time for predetermined cash payments (rents). A lease agreement must be evaluated to determine whether the transaction should be treated as a capital or operating lease.

Capital or Operating

All leases entered into when the State is the lessee and the lease meets any of the four capital lease criteria and the exercise of the fiscal funding or cancellation clause, if any, is determined to be remote (non-cancelable) should be reported as a capitalized lease. Leases which do not meet any of the four capital lease criteria and the lease is considered cancelable should be accounted for as an operating lease.

Reporting

The accounting and financial statement presentation for leases depends on the type of fund and the financial statements involved. The State uses three types of funds; 1) governmental, 2) proprietary and 3) fiduciary funds. Typically, the type of fund determines the measurement focus and the basis of accounting. Governmental funds use the current financial resources measurement focus and the modified accrual basis of accounting. Proprietary and fiduciary funds use the economic resources measurement focus and the accrual basis of accounting. Governmental funds record capital and operating leases as expenditures in the period incurred and do not report capital leases (assets and liabilities) in their fund financial statements. Proprietary and fiduciary funds capitalize the costs of capital leases and report the related liability in their fund financial statements. In addition to the fund financial statements, the State is required to prepare government-wide financial statements. Government-wide financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting and include government and proprietary funds, as well as, component units. Due to the differences between the measurement focus and the basis of accounting for governmental fund financial statements and government-wide financial statements, adjustments need to be recorded to accurately and properly report capital and operating leases in the government-wide financial statements.

Resources

The State provides information on the management of capital and operating leases in the State of Georgia Accounting and Procedures Manual¹ and the Capital Asset Guide² within the State of Georgia Accounting and

¹ State of Georgia Accounting Procedures Manual, Section 3, pages 3-2-17 through 3-2-20

² State of Georgia Accounting Procedures Manual, Section 4, Capital Asset Guide

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Procedures Manual. These resources provide information to assist organizations in accurately recording and properly reporting capital leases in their respective funds.

Capital or Operating Lease

Classification

A lease that transfers substantially all the benefits and risks inherent to the ownership of property should be accounted for as a capital lease (the acquisition of an asset and the incurrence of a liability) by the lessee (State/agency). All other leases should be classified as an operating lease.³

Criteria

If at its inception, a lease meets **one or more** of the four criteria, the lease must be classified, accounted and reported as a capital lease.⁴

- The lease transfers ownership of the property to the lessee by the end of the lease term, (for capital lease purchases of land this criterion must be met).
- The lease contains a bargain option purchase option (a provision allowing the State, at its option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable). However, the difference between the option price and the expected fair value must be large enough to make exercise of the option reasonably assured.
- The lease term is equal to 75% or more of the estimated economic life of the leased property. However, if 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, this criterion shall not be used for purposes of classifying the lease.
- The present value of the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as, insurance, maintenance and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90% of the excess of the fair value of the lease property to the lessor at the inception of the lease over any related investment tax credit by the lessor and expected to be realized by him. However, if 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, this criterion shall not be used for purposes of classifying the lease. It is required that the lessee will use their own incremental borrowing rate as a discount rate when calculating the present value unless the lessee is aware of the lessor's implicit rate of return and the lessor's rate of return is less than the lessee's implicit rate.

³ FASB Statement #13, paragraph 60

⁴ FASB Statement #13, paragraph 7

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Items to Review

Fiscal Funding or Cancellation Clause

A lease may contain a fiscal funding or cancellation clause indicating that the lease is cancelable (terminate lease without penalty) if the appropriating body does not allocate the necessary funds to make the required lease payments for the next budget period. However, when it has been determined the potential for cancellation of a lease agreement is remote the fiscal funding or cancellation clause should not prohibit the lease agreement from being capitalized. Therefore, if the cancellation of the lease is remote the State agencies should treat the fiscal funding or cancellation clause as not applicable for determining a lease as non-cancelable for financial reporting purposes.⁵

Leases within the Reporting Entity

Leases that have been entered into between departments, agencies or divisions where the leasing entity (department, agency or division) is part of the primary government for financial reporting purposes and has purchased an asset that is subsequently leased to other departments, agencies or divisions should not be included as an operating or capital lease. This should be considered ordinary operating expenditures/expenses.⁶

Leases that have been entered into between departments, agencies or divisions where the leasing entity is a component unit (regardless if it is part of the governmental unit entity for financial reporting purposes) should be treated in the same manner as any other lease agreement of the State.⁷

Leasehold Improvements

A leasehold improvement is an improvement made to a leased building by an agency 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 and 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.

Leases Executed through Purchase Order

Agencies executing a lease through a purchase order should apply the lease criteria of FASB Statement #13. While a formal lease document does 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 with the purchase order creates the contractual lease agreement.

Lease Modifications

⁵ GASB Codification L20.115-118

⁶ GASB Codification L20.121

⁷ FASB Statement #13, paragraph 29, GASB Codification L20.122

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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 and a termination of a lease. Agencies should apply FASB Statement #13 when these situations occur.⁸

Items to Review

Real Estate

Leases involving real estate are divided into the following categories:⁹

- leases involving land only
- leases involving land and buildings
- leases involving equipment as well as real estate
- leases involving only part of a building

Leases involving real estate require additional evaluation and agencies should apply FASB Statement #13 when classifying a real estate lease as either capital or operating.^{10,11}

Operating Leases with Scheduled Rent Increases

Agencies may enter as lessees into operating leases with scheduled rent increases (escalator clauses). These scheduled rent increase are fixed by the provisions in the lease. GAAP require lease rentals be accrued on a systematic and rational basis in connection with operating leases having scheduled rent increases. The rental schedule is considered a systematic and rational basis if the rent increases reflect economic factors related to the lease property such as, anticipated cost increases or anticipated increases in property values. In this situation, operating lease payments are due as they become payable. However, if no economic justification can be offered, rental costs should be recognized on a straight line basis over the term of the lease or the estimated fair value of the rental.¹²

Space Rental

State agencies are to evaluate leases involving space rental 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 will be considered an operating lease.

Leases below Capitalization Threshold

If a lease meets one or more of the capital lease criteria but is below the standard capitalization threshold established by the State for major capital asset classes; the lease will be considered an operating lease.

⁸ FASB Statement #13, paragraph 14

⁹ FASB Statement #13, paragraph 24

¹⁰ FASB Statement #13, paragraph 7

¹¹ FASB Statement #13, paragraphs 25-28

¹² GASB Statement #13, summary

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Valuation

Present Value of Minimum Lease Payments or Fair Value

A capital lease should be recorded at an amount equal to the lower of the present value of the minimum lease payments, excluding that portion of the payments representing executory costs such as, insurance, maintenance and taxes to be paid by the lessor, including any profit thereon or the fair value of the leased property at the inception of the lease. If the executory costs cannot be determined from the provisions of the lease, an estimate should be made.

Certain costs should be **included** and **excluded** when calculating the present value of the minimum lease payments.

- Include:
 - Minimum lease payments over the lease term
 - Guaranteed residual value at end of 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

An operating lease does not require that the minimum lease payments be capitalized. Therefore neither an asset nor liability is recorded at the inception of the lease.

Depreciation

A capital asset acquired through a capital lease should be depreciated using the State's normal depreciation policy for major capital assets if the provisions of the lease contain either of the following:

- 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 lease **do not contain the above criterion**, a capital asset acquired through a capital lease should be depreciated using the State's depreciation policy for major capital asset classes, **except the period of amortization shall be the lease term**.

The following are not depreciated:

- capital lease agreements involving **only** land and
- operating leases

Amortization and Allocation

An amortization schedule should be prepared when a lease meets one or more of the criteria for capital lease.

During a capital lease term, the minimum lease payment should be allocated, based upon the amortization schedule, between a reduction of the principal and interest expense.

During an operating lease term the minimum lease payment should be recognized as an expenditures/expense as they become payable.

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Reporting

Governmental Funds

Agencies entering into a capital lease should treat it in the same manner as long-term debt. The acquisition of a capital asset through a capital lease should be recorded similar to an outright purchase. Lease payments, including down payment, will be recorded consistent with principles for long-term debt. Lease payments (principal and interest) are reported when due.

In the **initial year only**, the lessee will report the purchase of a capital asset acquired through a capital lease as **capital outlay** and as **other financing source**. The amount **initially recorded and reported as a general capital asset** should equal the lower of the present value of the minimum lease payments excluding that portion of the payments representing executory costs such as, insurance, maintenance and taxes to be paid by the lessor, including any profit thereon or the fair value of the leased property at the inception of the lease.

Capital leases are not reported on government fund financial statements. However, the asset and related liability for capital leases should be recorded in the accounting records so that they can be reported in the government-wide financial statements.

Proprietary and Fiduciary Funds

Agencies will report costs associated with capital leases (asset and related liability) in the respective fund executing the lease agreement. Capital leases (asset and liability) are reported in their respective fund financial statements.

In the **initial year only**, the lessee will report the purchase of a capital asset acquired through a capital lease as **capital asset** and as **capital leases payable**. The amount **initially recorded and reported as a capital asset** should equal the lower of the present value of the minimum lease payments excluding that portion of the payments representing executory costs such as, insurance, maintenance and taxes to be paid by the lessor, including any profit thereon or the fair value of the leased property at the inception of the lease

Proprietary funds are also referred to as business-type activities.

Component Units

The State has component units in governmental, proprietary and fiduciary funds. Refer to the fund types on how to report capital and operating leases.

Government-wide Financial Statements

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 blended in the government-wide financial statements and discretely presented. Component units in fiduciary funds are not reported in the government-wide financial statements.

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Disclosure Requirements

GAAP requires the following disclosures for capital lease obligations:

- General description of leasing arrangements.
- The gross amount of assets recorded under capital leases presented by major asset classes.
- Minimum future lease payments for each of the next five years and for at least each five year increment thereafter, presenting a deduction for the amount of imputed interest to reduce the net minimum future lease payments to their present value.¹³
- Total minimum future sublease rentals.
- Total contingent rentals incurred.
- Amortization of leased assets (if not displayed) or statement that it is included as part of depreciation expense.¹⁴

GAAP requires the following disclosures for operating lease obligations:

- General description of leasing arrangements.
- Future minimum rental payments for each of the next five years and for at least each five year increment thereafter (only for non-cancelable leases of more than one year).¹³
- Minimum future sublease rentals (only for non-cancelable subleases).
- Current year rental costs (with separate amounts for minimum rentals, contingent rentals, and sublease rentals).¹⁵

Agency Requirements

SAO requires all agencies to complete and provide for each lease the following information:

- Form_Lease Agreement Data
 - Instructions provided

¹³ GASB Statement #38, paragraph 11

¹⁴ FASB Statement #13, paragraphs 13 and 16

¹⁵ FASB Statement #13, paragraph 16

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Bargain Purchase Option

A provision to allow the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Contingent Rentals

A contingent rental indicates that lease payments depend on a factor related to the future use of the leased property, such as machine hours of use or number of copies made. Accordingly, they are excluded from minimum lease payments in their entirety.

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, maintenance and taxes.

Fair Value

The price for which the property could be sold in an arm's length transaction between unrelated parties.

Guaranteed Residual Value

The estimate fair value of the leased property at the end of the lease term. The amount of the guaranteed residual value 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. Any portion exclusive of the guarantee is un-guaranteed.

Inception of the Lease

The date that a lease agreement or written agreement is signed and provided the property being leased is constructed or acquired by the lessor.

Incremental Borrowing Rate

The rate that, at the inception of the lease, the State would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

Lease Term

The sum of all the time periods, as applicable, but not beyond the date a bargain purchase option becomes exercisable:

- The fixed non-cancelable term – that period during which a lease is cancelable only a) on the occurrence of some remote contingency, b) with the lessor's permission, c) if a new lease is entered into between the same parties or d) on payment of penalty in an amount such that continuation of the lease appears, at the inception, reasonably assured.
- Period covered by bargain purchase options, an option that provides reasonable assurance at the inception date that it will be exercised because the rental is sufficiently lower than the expected rental for equivalent property under similar terms and conditions at the exercise date.
- Renewal periods when a penalty for failure to renew is so large that it appears there is reasonable assurance at the inception date the lease will be renewed.
- Ordinary renewal option periods during which a lessee's guarantee of the lessor's debt related to the leased property is expected to be in effect.
- Ordinary renewable option periods preceding the date a bargain purchase option becomes exercisable.
- Periods for which the lessor has the option to renew or extend the lease.

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Maintenance Agreements

Agencies may have an agreement to lease an asset, including maintenance costs. In this situation, the minimum lease payments should be calculated strictly on the amount of the payment that applies to the leased asset, without maintenance costs.

Minimum Lease Payments

The payment for leased property that the lessee is obligated or required to make in connection with the lease property. However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance and taxes in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

- The minimum rental payments called for by the lease over the lease term.
- Any guarantee by the lessee of the residual value at the expiration of the lease term, whether or not the payment of the guarantee constitutes a purchase of the leased property. When the lessor has the right to require the lessee to purchase the property at the termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made.
- Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the lease property. In this connection, it should be noted that the definition of lease term includes all periods if any for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty shall not be included in the minimum lease payments.

Related Parties

Two or more parties are related when at any time during the financial period:

- one party has direct or indirect control over the other party; or
- the parties are subject to the common control of the same source; or
- one party has influence over the financial and operating policies of the other party to the extent that the other party may be inhibited from pursuing at all time its own separate interests; or
- the parties, entering into a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests.