

# OREGON ACCOUNTING MANUAL

<b>SUBJECT:</b> Accounting and Reporting	<b>Number:</b> 15.60.30
<b>DIVISION:</b> Chief Financial Office	<b>Effective date:</b> July 1, 2012
<b>Chapter:</b> Accounting and Financial Reporting	
<b>Part:</b> Capital Assets	
<b>Section:</b> Capital Leases	
<b>APPROVED:</b> George Naughton, Chief Financial Officer	Signature on file

**PURPOSE:** This policy provides guidance on accounting and financial reporting for capital leases.

**AUTHORITY:** **ORS 293.590**  
 NCGA Statement No. 5  
 GASB Statement No. 34  
 GASB Statement No. 38  
 GASB Statement No. 62

**APPLICABILITY:** This policy applies to all state agencies included in the State’s annual financial statements, except for those agencies specifically exempted by [OAM Policy 01.05.00](#).

**DEFINITIONS:** A **lease** is a contractual agreement that conveys the right to use specific property for a specific period of time in return for stipulated, and generally periodic, cash payments.

A lease agreement is classified as a capital lease (in-substance purchase) when substantially all the risks and benefits of ownership are assumed by the lessee.

A **capital lease** is a lease that meets any *one* of the following conditions in (a) through (d) *and* meets the condition in (e):

- a. Ownership of the leased property transfers to the agency at the end of the lease.
- b. The lease contains a [bargain purchase option](#).
- c. The lease term is 75% or more of the estimated useful life of the leased property.
- d. The present value of the minimum future lease payments at the inception of the lease, excluding [executory costs](#), is 90% or more of the fair value of the leased property.
- e. In addition to one of the items above, the lease must be noncancellable.

A **bargain purchase option** is a provision in the lease agreement that allows the lessee to buy the leased property sometime during the term of the lease at a price considerably lower than the estimated fair value of the asset at the date the option becomes exercisable.

The lessee's **incremental borrowing rate** is the estimated interest rate the lessee would have had to pay if the lessee purchased the leased property and financed it over the period covered by the lease.

The lessor's **implicit borrowing rate** is the discounted interest rate that, when applied to the minimum future lease payments less executory costs of the lease and the unguaranteed residual value of the asset, causes the aggregate present value of the leased property to be equal to the fair value of the property to the lessor.

## **POLICY:**

101. Agency management is responsible to ensure proper accounting and reporting of capital leases. Agencies that enter into a lease agreement must apply the criteria above to determine if the transaction is a capital lease or an operating lease.
102. The state's capitalization threshold is \$5,000. Capitalize only leases for which the present value of the minimum future lease payments is at least \$5,000. Record the capital leased asset in general ledger (GL) account 0863, Capital Leased Property.
103. For leases meeting the criteria in a. and b. above, record the liability for future lease payments in GL account 1715, Lease-purchase Contracts Payable. For leases meeting the criteria in c. and d. above, record the liability for future lease payments in GL account 1716, Obligations Under Capital Lease,
104. Record capital leases at an amount equal to the present value of the minimum future lease payments, however the amount must not exceed the fair value of the leased property.
105. If an agency leases property and accounts for it in a [proprietary fund](#) or [fiduciary fund](#), they account for the capital lease within the accounts of that fund. If an agency leases property for general government purposes (using resources from [governmental funds](#)), they account for the capital lease in the [government-wide reporting fund](#). Record payments to reduce the liability in the governmental fund that originated the liability. Do not use a [debt service fund](#) to record payments on this type of liability unless legally mandated through an appropriation.
106. Depreciate lease-purchase contracts payable (GL 1715) over the estimated useful life of the asset. Depreciate obligations under capital lease (GL 1716) over the length of the lease. Refer to [OAM 15 60 20](#) on Depreciation and Amortization of capital assets for guidance on depreciation.
107. Agencies are responsible to provide required disclosure information to Statewide Accounting and Reporting Services (SARS) for financial statement note disclosure purposes. Agencies with audited financial statements should include disclosures required for capital leases in the notes to their financial statements.

## **PROCEDURE:**

### **Examination of Capital Lease Criteria**

108. For each lease agreement entered into, consider the criteria for capital leases to determine whether to classify the lease as a capital lease.
  - a. Transfer of ownership should be apparent in the terms of the lease.

- b. Bargain purchase option. Use professional judgment in determining whether the purchase option price will be a bargain price at the option date. The difference between the option price and the expected fair value must be large enough to make exercise of the option reasonably assured. If there is reasonable assurance at the start of the lease that the agency will exercise the purchase option, or it is the agency's intention at the start of the lease to exercise the purchase option, consider the option a bargain purchase option.
- c. Lease term at least 75% of useful life. The lease term is normally the fixed, noncancellable term of the lease. The lease term is at least 75% of the estimated economic life of the leased asset if, for example, an agency has a lease contract for a motor vehicle that extends for 48 months and the agency estimates the useful life of the vehicle at 60 months. In this case, the term of the lease runs for 80% of the normal life of the asset, meeting the criteria. If the term of the lease had been less than 45 months, the lease would not have qualified under this criterion since 45 months is 75% of the useful life of the asset.

In addition, if the beginning of a lease term falls within the last 25% of the total estimated useful life of the leased asset, including earlier years of use, consider the lease an operating lease.

- d. Lease payments at least 90% of fair value of leased asset. Lease payments include minimum rental payments based on the term of the lease and exclude executory costs such as payments for insurance, maintenance and taxes. The lease payments include any residual value guaranteed by the lessee at the end of the term of the lease as well as any penalties that the lessee must pay for failure to renew or extend the lease. If the lease contains a bargain purchase option, the lease payments include only the minimum future lease payments over the term of the lease and the bargain purchase option.

When determining the present value of lease payments, the lessee uses its incremental borrowing rate. The lessee uses the lessor's implicit interest rate if that rate can be determined and it is less than the lessee's incremental borrowing rate.

The lessee then compares the present value amounts to the fair value of the asset to determine if the present value of minimum future lease payments exceeds 90% of the fair value of the leased asset.

For example, the lessee:

Leases equipment for a 5-year period  
 Will make 5 annual payments of \$50,000  
 Will make the first payment upon signing the lease on 6/30/X1

Both the lessee's incremental borrowing rate and the lessor's implicit borrowing rate are 10%  
 Fair value of the property is \$230,000

Annual lease payments	\$ 50,000
From PV tables: Present value of an annuity due	x
Interest rate 10% and number of periods is 5	<u>4.16986</u>
Present value of minimum future lease payments	\$208,493

Present value of minimum future lease payments	\$208,493
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Divided by fair value of the property	<u>\$230,000</u>
Percentage of fair value	90.65%

Capitalize the lease at \$208,493 and report interest per the following schedule:

Date	Lease Payment	Interest @ 10%	principal	remaining liability
6/30/X1	-	-		208,493
6/30/X1	50,000	-	50,000	158,493
6/30/X2	50,000	15,849	34,151	124,342
6/30/X3	50,000	12,434	37,566	86,777
6/30/X4	50,000	8,678	41,322	45,454
6/30/X5	50,000	4,545	45,455	(0)

e. A cancellation clause allows the lessee to terminate at any time for any reason. If the lease contains a fiscal funding clause specifying the state may cancel the lease if the state does not appropriate the funds necessary to make the required lease payments, evaluate the likelihood that the state will exercise the clause. If the chances of the lease being canceled due to nonappropriation are remote (normally true for state government), consider the lease noncancellable.

109. If the lease does not meet any *one* of the above criteria in (a) through (d) *and* the condition in (e), record the lease as an operating lease in the agency's accounting records. See OAM 15 80 00 on Commitments for more information on operating leases.

### Accounting Transactions

110. When a lease meets the criteria of a capital lease, use the following entry to record an asset and liability in either a proprietary fund or the government-wide reporting fund:

**T-code 466:** Establish asset and liability for capital lease

DR 0863 Capital Leased Property	xxx	
DR 3074 Change in Capital Assets	xxx	
CR 3018 Invested in Capital Assets		xxx
CR 1715 Lease-Purchases Contracts Payable		xxx
or CR 1716 Obligations Under Capital Lease		

111. After making payment, reduce the liability for the principal portion of the payment only. Charge the interest portion to comptroller object 7400, Interest-Loans.

**T-code 459:** Reduce capital lease liability for principal payment only

DR 1715 Lease-Purchases Contracts Payable	xxx	
or DR 1716 Obligations Under Capital Lease		
CR 3600 GAAP Expenditure Offset-Capital Outlay		xxx

112. When capital leased property is disposed of, record an entry as follows:

**T-code 535:** Disposition of capital leased property

DR 0871 Accumulated Amortization-Capital Leased Property	xxx	
CR 0863 Capital Leased Property		xxx

If the capital leased property has any unamortized balance, make the follow entry:

**T-code 537:** Remove unamortized balance of capital leased asset

DR 3200 GAAP Revenue Offset-Gain(loss) on Disposition	xxx	
DR 3018 Invested in Capital Assets	xxx	
CR 0863 Capital Leased Property		xxx
CR 3074 Change in Capital Assets		xxx

113. At fiscal year end, reclassify the current portion of the capital lease liability (the principal amount that the agency must pay in the coming fiscal year) out of the noncurrent portion of the liability. For Lease-Purchase Contracts Payable, reclassify from GL account 1715 into GL account 1280. For Obligations Under Capital Lease, reclassify from GL account 1716 into GL account 1281. This reclassification ensures appropriate reporting of the current and noncurrent portions of the liability on the face of the statement of net assets.

### Financial Statement Reporting

114. In the year an agency acquires a new lease purchase in governmental funds, SARS reports both capital outlay expenditures and an other financing source to properly report leases incurred on the statement of revenues, expenditures, and changes in fund balances, as required by GAAP. SARS obtains the necessary information from agency year-end disclosure forms.
115. For lease-purchase contracts payable (GL 1715), agencies report payments on capital leases entered into for general government purposes as capital outlay (for principal amount) and debt service (for interest expenditure) in **R\*STARS**. For governmental fund financial statement reporting, SARS reclassifies the capital outlay expenditures to debt service principal expenditures. This eliminates the expenditures for reporting in the government-wide financial statements. SARS obtains the necessary information from agency year-end disclosure forms.
116. For obligations under capital lease (GL 1716), agencies report expenditures for payments on a capital lease entered into for general government purposes as capital outlay expenditures. For governmental fund financial statement reporting, SARS reclassifies the capital outlay expenditures to debt service principal and interest expenditures, as applicable. This eliminates the principal expense for reporting in the government-wide financial statements. SARS obtains the necessary information from agency year-end disclosure forms.
117. The SARS reports capital leased property as part of Buildings, Property, and Equipment within the capital asset section of the proprietary fund statement of net assets, the statement of fiduciary net assets, and the government-wide statement of net assets.
118. SARS reports both lease-purchase contracts payable and obligations under capital lease as part of Obligations Under Capital Lease on the proprietary fund statement of net assets, the statement of fiduciary net assets, and the government-wide statement of net assets.

119. SARS reports depreciation expense, including that associated with capital leased assets, as a separate line item within operating expenses in the proprietary fund statement of revenues, expenses, and changes in fund net assets. SARS reports depreciation expense as administrative expense on the statement of changes in fiduciary net assets. SARS reports depreciation expense in the applicable function/program for governmental or business-type activities in the government-wide statement of activities.
120. SARS reports accumulated depreciation for capital assets, including that associated with capital leased assets, as a contra account to capital assets on both the proprietary funds statement of net assets and the government-wide statement of net assets. SARS nets accumulated depreciation for capital leased assets against Buildings, Property, and Equipment in the statement of fiduciary net assets.

### **Disclosure Requirements**

121. SARS includes disclosure information for capital leased assets along with disclosure information for all other capital assets as described in [OAM 15.60.10](#).
122. SARS discloses the following information specific to capital leases:
  - a. a description of the general leasing arrangements
  - b. the gross amount of assets recorded under capital leases
  - c. minimum future lease payments for each of the next five fiscal years and for 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
  - d. depreciation of leased assets

SARS gathers the detail for this disclosure on agency year-end disclosure forms.