Capital and Operating Leases

Policy Objectives:

The purpose of this policy is:

- To identify criteria that are used to determine if a contractual agreement for the use of property is a capital lease or an operating lease,
- To ensure consistent application of agency accounting practices and established financial reporting standards for leases by the lessors (sellers) and lessees (buyers or customers), and
- To determine when ownership risks and benefits are transferred from the lessor to the lessee.

Background Information:

For purposes of this policy, the lessor is the seller of the property and the lessee is the party that uses the property. The lessee may eventually purchase the property, if the lease permits.

A Lease is a contractual agreement between a lessor and a lessee that conveys to the lessee the right to use specific property (real or personal) owned by the lessor, for a specific period of time in return for cash payments.

The lessee agrees to a monthly lease charge, which includes equipment cost, interest and administrative fees. At the end of the lease period, the lessee is given the option to purchase the equipment at a price set forth in the lease agreement.

All leases may be classified for accounting purposes as either of the following types (the accounting treatment is noted parenthetically):

- Operating leases (noncapitalization method), or
- Capital leases (capitalization method).

Authority:


Business Risks:

- In a capital lease arrangement the lessee’s equipment may be recorded as an inventory item on the lessor’s fixed assets records, thus overstating the lessor’s assets and understating the lessee’s assets.
- The lessor and/or the lessee may record the lease transactions erroneously, i.e. applying the incorrect accounting treatment that reports rental revenue, and fixed asset and/or expense amounts inaccurately.
Policies and Procedures:

PART ONE - GENERAL

1. Customer Criteria - Leasing agreements are available for all divisions of Admin.

2. Formal Agreement - A contract must be signed by all parties involved for the lease agreement to be valid.

   A. Essential provisions for inclusion in a capital lease agreement are listed as follows:
      1. Lessor (seller) responsibilities,
      2. Lessee (buyer or customer) responsibilities,
      3. Complete description of the lessor’s equipment to be used by the lessee (include make, model, serial number),
      4. Delivery date and site for the leased equipment,
      5. Billing arrangements including periodic payment amounts, implementation schedule, interest rate, and administrative fees,
      6. Conditions for modification or extension of the agreement and who will authorize the changes,
      7. Specify who is financially and operationally responsible for the maintenance and repairs of the leased equipment,
      8. Cancellation criteria specifically stating how the agreement may be canceled,
      9. Authorized signatures must include the customer, attorney general, assistant commissioner(s) of selling agency, and the Materials Management Division,
      10. An amortization schedule detailing the equipment purchase price for any given month, the payment due date, and the portion of payment applied to the following:
          11. Principal,
          12. Interest, and
          13. Administrative fees,
          14. Default provisions,
          15. Lease administrator at the selling agency,
          16. Prepayment provisions (penalties for cancellations),
          17. Bargain purchase options, and
          18. Lease term (beginning and end dates of the agreement).

   B. Distribution of the Executed Lease Agreement - Copies will be distributed to parties pertinent to the agreement. These parties may include:
      1. Lease agreement manager of the seller agency,
      2. Accounts receivable manager of selling agency,
      3. Lease agreement manager of buying agency, and
      4. The Financial Management and Reporting (FMR) Division accountant who is responsible for compiling financial statements of the lessor and/or the lessee.

3. Tracking Fixed Assets in a Capital Lease Arrangement

   A. The lessor should not affix a fixed asset number to the equipment identified in the capital lease agreement.
   B. The lessor is strongly encouraged to maintain a separate property management system for leased equipment.
   C. The lessee should attach a fixed asset number to the identified equipment.

4. Determining if a Lease is a Capital Lease or an Operating Lease

   A. A lease may be classified as a capital lease if it meets one or more of the following four criteria:
      1. The lease transfers ownership of the property to the lessee.
2. The lease contains a bargain purchase option.

3. The lease term (including any bargain renewal options) is equal to 75% or more of the economic life of the lease property.

4. The present value of the lease payments (excluding executory cost) equals or exceeds 90% of the fair value of the leased property.

B. A lease may be classified as an operating lease if it does not meet any of the four criteria identified in Part I, item 4A.

C. The following flow chart depicts the decision path followed to determine if a lease arrangement should be accounted for as an operating or capital lease:
PART TWO– LESSOR’S (SELLER’S) RESPONSIBILITIES IN A CAPITAL OR OPERATING LEASE AGREEMENT

1. Customer billing process – A monthly invoice will be sent to the lessee (customer) that shows the periodic payment amount. This amount represents principal, interest, and administrative fees for a capital lease arrangement, or the rental fee for an operating lease arrangement.

   A. Upon receipt of a signed lease agreement, the lessor’s (seller’s) lease agreement manager should advise the accounts receivable department of the terms of the agreement. The following information should be given to the accounts receivable department for proper invoicing:
      1. Start and end dates of the agreement,
      2. Lease amounts, and
      3. The final purchase price.

   B. The lessor’s (seller’s) accounts receivable department should enter the information into the billing system.

   C. It is preferable to have the accounts receivable department maintain a copy of the executed lease agreement for reference.

2. Cancellation Criteria – The cancellation criteria will vary with each lease agreement.

3. Capital Lease Account Monitoring Process

   A. The customer’s billings should be monitored by the lessor’s (seller’s) accounts receivable staff (i.e. periodically review customer account balances for payments in arrears).

   B. The lease agreement manager, or designee, should issue written notice to the customer when the lease agreement ends.
      1. At a minimum, this notice should include a reminder of the lease end date, and a confirmation of whether the lessee (customer or buyer) will return or purchase the equipment.
      2. Should the customer exercise the option to purchase the equipment, this notice should also contain the bargain purchase price.

PART THREE – LESSEE’S (CUSTOMER’S) RESPONSIBILITIES IN A CAPITAL OR OPERATING LEASE AGREEMENT

Lessee (Customer) Responsibilities – Lessee (customer) responsibilities are outlined in the terms of the contractual agreement. Since this is a contractual agreement, the lessee (customer) should be aware of all contractual provisions.

Forms:
FMR-001, Intra-Agency Transfer of Property
See Also:
FMR-1G-01, Property Management
FMR-4A-01, Purchasing Process (Ordering, Receiving, and Payment Processing)

Refer to the Glossary for definitions of the key terms listed below:
- bargain purchase option
- economic life test
- bargain renewal option
- executory costs
- capital leases
- minimum lease payments
- direct-financing lease
- operating leases
- discount rate
- residual value