

Leasing 101 Capital - vs.- Operating Leases

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Agenda

- Different lease types
- Criteria to determine lease types
- Coding of lease transactions
- Closure/end of lease

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State and Federal Rules

- OAC 5101:9-4-11
- 2 C.F.R. 200.465 and 2 C.F.R. 200.449
- FASB 13

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Leasing Terms

- Lessor – The vendor or owner of the asset
- Lessee – The county agency leasing the asset
- Economic Life – Expected/depreciable life of an asset a.k.a. useful life
- Fair Market Value – Estimated price that knowledgeable buyers and sellers are willing to accept
- Note: Leases are subject to procurement requirements

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Capital Lease - General

- Capital leases are similar to a financed purchase
- The lessee generally takes ownership at the end of the lease
- For financial reporting purposes it is treated as an asset purchase

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Operating Lease - General

- Operating lease is similar to paying rent
- At the end of the lease the asset is returned to the vendor (lessor)
- For financial reporting purposes it is treated as a monthly operating expense

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Capital Lease - Details

A lease is considered a capital lease if any one of the following four criteria apply:

1. The life of the lease is 75% or greater of the estimated economic life
2. The lease contains a purchase/buy-out agreement for less than fair market value (bargain purchase option)
3. The lessee gains ownership at the end of the lease period
4. The present value* of lease payments is greater than 90% of the asset's market value

* Present value calculators (calculatorsoup.com) on the internet

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Capital Leases - Additional Criteria

- A bargain renewal option can also make a lease qualify as a capital lease and must be reviewed against criteria 1 and 4 when determining lease type
- Assets leased late in the asset life (last 25%) must be reviewed against criteria 2 and 3 when determining lease type

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Capital Lease – Criteria 1

- The term of the lease is 75% or more of the estimated economic life of the asset
 - If the lease term is 75% or greater of the economic life as determined by the county schedule, the lease is a capital lease and must be accounted for as such
 - If no county schedule is available use DAS schedule

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DAS Asset Life Table

- The link for DAS asset life table is:
<http://das.ohio.gov/Divisions/GeneralServices/AssetManagementServices/tabid/312/Default.aspx>
 - Then select “Profile ID’s” on the right side menu options
 - The table will open in Excel format

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Capital Leases – Criteria 2

- The lessee has an option to purchase the asset at a bargain price at the end of the lease (bargain purchase option)
 - If the lessee has the option to purchase the asset at a bargain price, then the lease is a capital lease and must be accounted for as such
 - A bargain purchase option only exists if the purchase price is significantly below market value

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Capital Leases – Criteria 3

- The lease conveys ownership to the lessee during or at the end of the lease
 - If at any time ownership is transferred the lease is a capital lease and must be accounted for as such

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Capital Leases – Criteria 4

- The present value of the total minimum lease payments (principle + interest) as of the beginning of the lease, equals or exceeds 90% of the current fair market value of the asset
 - There are calculation tools on the internet that can assist in calculating the present value of lease payments (i.e. calculatorsoup.com) – search for “annuities present value”

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Operating Leases

- If the lease does not meet any of the criteria mentioned earlier then it is an operating lease
 - An operating lease is treated as an operating expense and is charged to the appropriate funding source

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Recording Capital Lease Transactions

- A capital lease payment includes principle and interest and can include other operating costs (i.e. insurance, maintenance agreements, etc.)
- Interest and operating costs are expensed to the appropriate funding source in the month they are incurred

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Recording Capital Lease Transactions

- The principle portion of capital assets are depreciated and expensed over the useful life of the asset as opposed to the life of the lease agreement
- To calculate the depreciation entry sum the total principle payments for the lease and divide that amount by the number of months of useful life of the asset

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Recording Capital Lease Transactions

On a monthly basis:

- Operating portion of the lease payment is charged to the appropriate funding source
- Principle portion is charged to local funds

- Monthly depreciation of the asset is charged to the appropriate funding source
- An offsetting entry of the monthly depreciation is made against the local funds

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Coding a Capital Lease

- The monthly lease payment is broken up into two entries
 - Entry one is for the operating and interest portion of the payment and is coded – appropriate project code – account 521092
 - i.e. JFSFA010-521092
 - Entry two is the principle portion of the lease and is coded as JFSF?899-539152

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Coding a Capital Lease

- The principle payments are reimbursed through the depreciation process
 - First, calculate the total principle to be paid over the life of the lease and divide that amount by the number of months of its useful life
 - This calculated amount is your monthly depreciation expense

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Coding a Capital Lease

- The depreciation entry is:
 - A positive entry to the appropriate project – account 521092
 - A negative offsetting entry to JFSF?899-592003
- Over the useful life of the asset this entry will reimburse the local funds for the principle portion of the lease payments

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Coding an Operating Lease

The total monthly payment is charged to the appropriate funding source

For example, to charge the PA shared cost pool you would use: JFSFA010-521092

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Closure/End of Leases

- **Operating**
 - assets are returned to the lessor and financial obligation normally ends
- **Capital**
 - assets may or may not be returned to the lessor, depending on the terms of the lease
 - disposal of assets needs to be recorded on inventory and fixed asset records
 - gain or loss needs to be calculated and coded accordingly

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Summary

- Before entering into a lease agreement, agencies need to determine if the lease is an operating or a capital lease
- Operating Leases treated as normal operational cost
- Capital Leases depreciated over life of asset
 - Coding for Principle of asset
 - Coding for Interest and Other associated costs
- **Additional Note:** Maintenance costs are not allowable if already included in the rental agreement or results in an increase in the asset's permanent value.

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Unallowable Costs

- Based on terms of the lease, your agency will need to be aware of potential unallowable costs.
- Examples:
 - If agency has a maintenance agreement that includes service/repairs, but the agency has someone else perform this service, the agency cannot charge those costs to Federal funding sources as it should have been covered by the lease.
 - Toner cartridges, agency cannot claim cost of toner if supply of toner is part of the lease agreement.
 - An agency leasing their building decides to do a major renovation or build an addition to the building. This would not be considered maintenance. The agency would need to follow proper procurement process and treat the project as a capital expenditure since the project will increase the permanent value of the asset, as noted in 2 CFR 200.452 and OAC 5101:9-4-11(C)(4)(b).

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Points To Ponder

- Purchasing Asset
 - Usually cheapest option
 - Requires immediate fronting of local cash
- Capital Lease
 - Usually the agency will eventually own the asset
 - May Require some fronting of local cash as lease payment and depreciation schedules may vary
- Operating Lease
 - Doesn't require any fronting of local cash
 - Agency will never own the asset

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QUESTIONS ?



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