

ACCOUNTING AND REPORTING FOR LEASES
AND INSTALLMENT PURCHASE CONTRACTS

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ACCOUNTING AND REPORTING FOR LEASES
AND INSTALLMENT PURCHASE CONTRACTS

"That all men are by nature equally free and independent
...with the means of acquiring and possessing property...."

--George Mason,
Virginia Bill of Rights (June 12, 1776)

I. INTRODUCTION

This chapter outlines the accounting procedures for the recording and reporting of leases and for the recording of installment purchase contracts. These procedures are in general conformance with the Financial Accounting Standards Board (FASB) Statement No. 13, Accounting for Leases, issued in 1976 by the Financial Accounting Standards Board (FASB). The Government Accounting Standards Board (GASB) requires adherence to FASB pronouncements issued before 1989.

II. REQUIREMENT

Leases should be recorded so that expenditures and future commitments for leases can be reported at fiscal year-end. Assets and liabilities for capital leases defined in this chapter must be recorded accordingly at the end of each fiscal year.

Installment purchases should be handled in essentially the same manner as capital leases if they fit the definition of capital leases. Otherwise, they should be handled as operating leases.

As indicated in Business and Finance Bulletin [BUS-43](#), Part 6, section II.B., approval is required by the External Finance Office for the interest factor of all leases over \$50,000 and by the Vice President - Financial Management for leases with a total cost exceeding \$1,000,000.

Section VI below details the procedures for capitalization from unexpended plant funds and current funds.

III. DEFINITIONS

- **Bargain Purchase Option**

A lease provision allowing the lessee, at its option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property.

- **Economic Life**

The estimated remaining period during which the property is expected to be of economic use by one or more users, with normal repairs and maintenance, for the purpose that it was intended at the inception of the lease.

- **Installment Purchase Contract**

A written contract, executed by the University (buyer) and another party (seller), containing all the terms and conditions for the acquisition of personal or real property by means of scheduled installment payments of specific amounts of money during the life of the contract. Title either (a) remains with the seller until the total contract amount has been paid, but the University has the right to use and take possession of the property during the life of the contract, or (b) is conditionally transferred to the University, subject to payment in full, accompanied with a Uniform Commercial Code (UCC) filing.

Installment purchases meeting the definition of a capital lease (refer to section IV below) must follow the accounting procedures as outlined in section VI.A. below. Installment purchases not meeting the criteria for a capital lease are to be treated as operating leases. However, with the approval of the campus controller, a liability may be established for installment purchases under \$100,000 for capital assets; accounting procedures for capital leases would then be followed.

- **Lease Contract With Purchase Option**

A written contract, executed by the University (lessee) and another party (lessor), containing the essential terms and conditions for the use or possession of personal or real property by the University, in

III. DEFINITIONS (Cont'd.)

exchange for scheduled payments of specific amounts of money during the term of the contract. The lessee has the option to purchase the property either during the life of the lease or at its expiration. All or a portion of the lease payments may apply toward the purchase of the property, as provided in the contract. Title remains with the lessor until the purchase option is exercised.

• **Remote Contingency**

A fiscal funding clause, commonly found in a lease agreement, provides that the lease is cancelable if the funding authority does not appropriate the funds necessary for the University to fulfill its obligations under the lease agreement.

(This clause is not a factor because in most University leases funding will be provided; therefore, the University shall not use the fiscal funding clause as justification to treat a capital lease as an operating lease. See FASB Technical Bulletin No. 79-10.)

• **Straight Lease or Rental Contract**

A written contract, executed by the University (lessee) and another party (lessor), containing the essential terms and conditions for the use or possession of personal or real property by the University, in exchange for scheduled payments of specific amounts of money during the life of the contract. At the end of the contract, the property is returned to the lessor in a condition and at a place as agreed to by the parties. Title remains with the lessor.

IV. CAPITAL LEASE

A. REQUIRED ELEMENTS IN A CAPITAL LEASE

A capital lease must contain the following elements:
(see Exhibit A for the Diagram for Required Elements of a Capital Lease)

- 1) The leased asset is a capital asset and has a current market value (current cash purchase price) of \$100,000 or more; and

- 2) The lease is non-cancelable; a lease is considered non-cancelable if it ceases to be in force:
- Only upon the occurrence of some remote contingency;
 - Only with the permission of the lessor;
 - Only if the lessee enters into a new lease with the same lessor; or
 - Only upon payment by the lessee of a penalty in an amount such that continuation of the lease appears, as at inception, reasonably assured; and
- 3) The lease meets one or more of the following four criteria:
- the lease transfers ownership of the property to the University by the end of the lease term;
 - the lease contains a bargain purchase option (all leases with a bargain purchase option for hospital, auxiliary, or service enterprises, where there is a likelihood that the option will be exercised, should be considered as capital leases);
 - the lease is equal to 75% or more of the estimated economic life of the leased property (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); or
 - the present value of rental or other minimum lease payments equals or exceeds 90% of the fair value of the leased property less any investment tax credit retained by the lessor.

B. SPECIFIC CONSIDERATIONS

The four criteria under section IV.A.3. above require evaluation of the property, lease term, rent and rights to acquire the property, if any. In particular, the 90% test in section IV.A.3. is of concern in leases

IV. CAPITAL LEASE

B. SPECIFIC CONSIDERATIONS (Cont'd.)

with longer terms and/or high rents. This test requires that the total rent payable over the lease term be discounted to the present value and be less than 90% of the property's fair market value or be considered a capital lease. In performing this calculation, the following considerations apply:

1. Lease Term

Options to extend the lease may be considered part of the lease term, if the rental for those options is potentially less than the market rent. For example, if, on the date of the extension, the rent is substantially lower than the fair market rent, or the option is so favorable that its exercise is assured, then the option must be included in the lease term discounted for the evaluation.

2. Rental

All payments that the tenant is obligated to make, or can be required to make, in connection with the leased property must be included as rental. This includes the payments for tenant improvements made by the landlord, but excludes "executory" costs, such as insurance, maintenance, and taxes. For example, up front cash payments or additional rent to amortize tenant improvements would be included. However, operating expense payments including the component of rent attributable to operating expenses in a gross lease would not be included (i.e., base year operating expenses plus pass through expenses).

3. Discount Rate

In virtually all cases, the applicable interest rate will be the tenant's incremental borrowing rate, e.g. the rate at which The Regents' most recent bond pool was sold or the rate of a related index.

In order to avoid **debt by accident**, any lease that may meet the criteria for a capital lease must be thoroughly examined in light of the above considerations and, if appropriate, the structure of

the arrangement modified to qualify for operating lease treatment. Real property leases should be capitalized if they contain the above elements. The applicability of the accounting rules in this area can be complex. As needed, campuses may consult with either Financial Management or the Real Estate Services Group at the Office of the President. Ultimately, the University's accounting staff make the determination of whether to characterize and record a University lease as a capital rather than an operating lease. The outside auditors may review the basis for these determinations.

V. OPERATING LEASE

Any lease not meeting the capital lease criteria is considered to be an operating lease.

A. SCHEDULED RENT INCREASE ADJUSTMENT

- 1) In FASB Statement No. 13, paragraph 15, the following definition is provided with regard to the recording of operating leases:

Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis. If another systematic and rational basis is more representative of the time pattern in which the use benefit is derived from the leased property, such a basis shall be used. Systematic and rational lease increases include:

- Increases over the term that are intended to cover economic factors such as property value appreciation or increases due to inflation, and
 - Lease payments which increase with increased availability of the property to the lessee.
- 2) All operating leases that have an average annual expenditure of \$500,000 or more must be reviewed by the campus accounting office to determine if the lease payment requirements are artificially lower in some periods; if so, adjustments using one of the following would be required:
 - A straight line basis over the lease term, or

V. OPERATING LEASE

A. SCHEDULED RENT INCREASE ADJUSTMENT (Cont'd.)

- The estimated fair value of the rental. The implicit financing should be accounted for using the interest method. That is, interest should be calculated for each period based on the outstanding accrued lease payable. This should result in a constant rate of interest over the lease term.

The campus accounting office should establish a balance sheet account in the prepayment or liability section in Current Funds if an adjustment is required. Each year the campus must adjust the balance sheet account so that by the time the lease terminates the balance will be zero.

The accounting would be as follows:

Dr. Expenditure Account	X-XXXXXX-XXXXX-X-XXXX
Cr. Liability Account	X-11XXXX
	or
Dr. Prepaid Account	X-11XXXX
Cr. Expenditure Account	X-XXXXXX-XXXXX-X-XXXX

Usually leases of this magnitude would only pertain to leases of real estate. An example would be a ten-year real estate lease with the first year free. In this instance, if the average annual cost is \$500,000 or more, the first year would require a debit to the expenditure account and a credit to a liability account. This liability account would be amortized (debited) over the nine year life with the actual expense as the payments are made. Adjustments are not required when the increase is based on a cost of living index.

B. LEASES FOR LAND

If land is the sole item of property leased, the University must account for it as an operating lease. If there is a transfer of ownership at the end of the lease agreement or the lease contains a bargain purchase option, the University must account for it as a capital lease. Other criteria that may qualify a lease as a capital lease do not apply to land leases.

VI. ACCOUNTING PROCEDURES

A. CAPITAL LEASE

All leases meeting the capital lease criteria must be capitalized. The capitalized value should be the equivalent of the cash purchase price as of the inception date of the lease; interest or other financing costs must not be included. The capital leases can be capitalized either through Unexpended Plant funds or Current funds. Unless indicated as a Budget Journal, all journal entries in the following examples are financial:

1. Capitalization Through Unexpended Plant Funds

a. Initial Entries

1) Budgetary Entry

To record the appropriated funds for capital lease:

Unexpended Plant
Dr. Capital Lease Plant Reserve
X-1015XX-015XX
Cr. Capital Lease Purchase
X-9XXXXXX-015XX-9

2) To record the capital lease purchase:

Unexpended Plant
Dr. Capital Lease Purchase
X-9XXXXXX-015XX-X-XXXX
(Sub 1 or 3, object
code = CAAN or 9000)
Cr. Capital Lease Plant Reserve
X-1015XX-015XX-1560

b. Year-end Capitalization Entries

The payment of the capital lease installments during the year creates an equity in the property. The capitalization entries are as follows:

1) To reverse the Budgetary entry (Section VI.A.1.a.1) above):

VI. ACCOUNTING PROCEDURES

A. CAPITAL LEASE

1. Capitalization through Unexpended Plant Funds
- b. Year-end Capitalization Entries (Cont'd.)

Budgetary Entry

Unexpended Plant

Dr. Capital Lease Purchase
X-9XXXXX-015XX-9
Cr. Capital Lease Plant Reserve
X-1015XX-015XX

- 2) To close expenditures and fund balance
(Section VI.A.1.a.2) above):

Unexpended Plant

Dr. Capital Lease Plant Reserve
X-1015XX-015XX-1560
Cr. Capital Lease Purchase
X-9XXXXX-015XX-X-XXXX

- 3) To capitalize the value of the asset
resulting from the capital lease:

Investment in Plant

Dr. Equipment (or Buildings and
Structures ...) X-1018XX-XXXXX(-CAAN)
Cr. Investment in Plant
X-10199X-XXXXX-3XXX

Capitalization Transaction Codes Table:

Capitalization-Real Estate-Campus	3670
Capitalization-Real Estate-Med Ctr	3770
Capitalization-Building & Struct-Campus	3671
Capitalization-Building & Struct-Med Ctr	3771
Capitalization-Fixed Equipment-Campus	3672
Capitalization-Fixed Equipment-Med Ctr	3772
Capitalization-General Improvemt-Campus	3673
Capitalization-General Improvemt-Med Ctr	3773
Capitalization-Software>10M-Campus	3674
Capitalization-Software>10M-Med Ctr	3774
Capitalization-Software<10M-Campus	3675
Capitalization-Software<10M-Med Ctr	3775
Capitalization-Equipment-Campus	3676
Capitalization-Equipment-Med Ctr	3776
Capitalization-Library Material & Coll	3677
Capitalization-Library Rare Books & Coll	3678
Capitalization-Intangible Assets-Campus	3680
Capitalization-Intangible Assets-Med Ctr	3780
Capitalization-Infrastructure-Campus	3681
Capitalization-Infrastructure-Med Ctr	3781
Capitalization-Special Collectns-Campus	3682
Capitalization-Special Collectns-Med Ctr	3782

- 4) To record the capital lease liability at the capitalized value of the asset:

Investment in Plant
Dr. Investment in Plant
X-10199X-XXXXX-3685
Cr. Capital Lease Liability
X-1019XX-XXXXX

For this transaction, the transaction code 3XXX under section VI.A.1.b.3) Capitalization Transaction Codes Table will net to zero with transaction code 3685 under VI.A.1.b.4) above. Since the plant expenditure has been reversed in Unexpended Plant Funds (see VI.A.1.b.2) above), the campus will not use the transaction code 3610 for these entries.

2. Capitalization Through Current Funds

- a. To capitalize the value of the asset resulting from the capital lease:

Investment in Plant
Dr. Equipment (or Buildings and Structures...) X-1018XX-XXXXX(-CAAN)
Cr. Investment in Plant X-10199X-XXXXX-3XXX

Capitalization Transaction Codes Table:

Capitalization-Real Estate-Campus	3070
Capitalization-Real Estate-Med Ctr	3170
Capitalization-Building & Structure-Campus	3071
Capitalization-Building & Structure-Med Ctr	3171
Capitalization-Fixed Equipment-Campus	3072
Capitalization-Fixed Equipment-Med Ctr	3172
Capitalization-General Improvement-Campus	3073
Capitalization-General Improvement-Med Ctr	3173
Capitalization-Software>10m-Campus	3074
Capitalization-Software>10m-Med Ctr	3174
Capitalization-Software<10m-Campus	3075
Capitalization-Software<10m-Med Ctr	3175
Capitalization-Equipment-Campus	3076
Capitalization-Equipment-Med Ctr	3176
Capitalization-Library Material & Coll	3077
Capitalization-Library Rare Books & Coll	3078
Capitalization-Intangible Assets-Campus	3080
Capitalization-Intangible Assets-Med Ctr	3180
Capitalization-Infrastructure-Campus	3081
Capitalization-Infrastructure-Med Ctr	3181
Capitalization-Special Collectns-Campus	3082
Capitalization-Special Collectns-Med Ctr	3182

VI. ACCOUNTING PROCEDURES

A. CAPITAL LEASE

2. Capitalization through Current Funds (Cont'd.)

- b. To record the capital lease liability at the capitalized value of the asset:

Investment in Plant

Dr. Investment in Plant X-10199X-XXXXX-3085
Cr. Capital lease liability X-1019XX-XXXXX

For this transaction, the transaction code 3XXX under section VI.A.2.a. Capitalization Transaction Codes Table above will net to zero with transaction code 3085 under section VI.A.2.b. above. Since there has been no expenditure recorded in Current Funds, there will be no elimination of current fund expenditure to transaction code 0560 for this transaction.

3. Year-End Entries

The following year-end entries apply to all capital leases (Section VI.A.1. and 2. above):

- a. During the fiscal year the lease payments will be recorded as current fund expenditures. (Object code 5600 or 5700 should be used for payments under capital leases; as an option, object code 9070 or 9970 with sub 4 may be used. Use object codes 5600 and 9070 for all payments except those for computer equipment; use object codes 5700 and 9970 for payments related to computer equipment.)

In accordance with Fiscal Closing Procedures, these expenses will be reclassified to a fund balance transfer to Retirement of Indebtedness. The principal and interest charges may be done in summary. If the expenses are in Current Funds, the transfer to Retirement of Indebtedness would be recorded as follows:

Current Fund

Dr. Unexpended Balances X-119XX0-XXXXX-0544
Cr. Expenditure Account X-XXXXXX-XXXXX-X-XXXX

Retirement of Indebtedness

Dr. Retirement of Indebtedness
Fund-Principal X-1017XX-XXXXXX-21XX
Dr. Retirement of Indebtedness
Fund-Interest X-1017XX-XXXXXX-22XX
Cr. Retirement of Indebtedness
Fund X-1017XX-XXXXXX-3045

Principal Repayment Transaction Codes Table:

Aux. Ent. - Repayment of Principal	2120
Med. Ctr. - Repayment of Principal	2150
Other - Repayment of Principal	2180

Interest Transaction Codes Table:

Aux. Ent. - Payment of interest	2220
Med. Ctr. - Payment of interest	2250
Other - Payment of interest	2280

Transaction codes of 0544 and 3045 need to offset each other between Current Fund and Retirement of Indebtedness funds.

If the expenses are in Renewals and Replacements, the transfer to Retirement of Indebtedness would be as follows:

Renewals and Replacements

Dr. Unexpended Balance X-119710-XXXXXX-3400
Cr. Expenditure Account X-XXXXXX-XXXXXX-X-XXXX

Retirement of Indebtedness

Dr. Retirement of Indebtedness
Fund-Principal X-1017XX-XXXXXX-21XX
Dr. Retirement of Indebtedness
Fund-Interest X-1017XX-XXXXXX-22XX
Cr. Retirement of Indebtedness
Fund X-1017XX-XXXXXX-3400

(See Principal Repayment Transaction Codes Table above.)

Transaction code 3400 needs to be offset between Retirement of Indebtedness and Renewals and Replacements.

- b. To recognize the liability reduction resulting from capital lease payments made during the year, exclusive of interest expense:

VI. ACCOUNTING PROCEDURES

A. CAPITAL LEASE

3. Year-End Entries (Cont'd.)

Investment in Plant

Dr. Capital Lease Liability X-1019XX-XXXXX

Cr. Investment in Plant X-10199X-XXXXX-35XX

Reduction of Liability Transaction Codes Table:

Aux. Ent. - Repayment of Principal 3524

Med. Ctr. - Repayment of Principal 3529

Other - Repayment of Principal 3536

The amounts in codes 35XX should equal the amounts in the principal repayment transaction codes 21X0 in Retirement of Indebtedness.

B. OPERATING LEASE

For straight leases or rental contracts, charge departmental supplies and expense; for rental of space, use object code 5100; for equipment-other, use object code 5300; and for computer equipment, use object code 5400. For leases of computer equipment with purchase options, charge departmental supplies and expense; for equipment-other, use object codes 5310 and 9060; and for computer equipment, use object codes 5410 and 9960.

Use the object code 9400 (with sub 4) to denote rental allowance credits. This object code is used to record any rental allowance credits which may be received when a purchase option is exercised. If a purchase option is exercised, the campus will record the following entries:

- 1) To record the purchase option payment and rental allowance credits if any:

Current Fund

Dr. Expenditure Account (gross of purchase option payment and rental allowance credits)

X-XXXXXX-XXXXX-X-5XXX

Cr. Expenditure Account (rental allowance credits)

X-XXXXXX-XXXXX-X-94XX

Cr. Cash

X-XXXXXX

- 2) To capitalize the purchase option payment, net of rental allowance credits, for the asset:

Investment in Plant
Dr. Equipment (or Buildings and Structures) X-1018XX-XXXXX(-CAAN)
Cr. Investment in Plant X-10199X-XXXXX-3XXX

(see Capitalization Transaction Codes Table under section VI.A.2.a. above.)

- 3) To eliminate capitalized expenditures from current funds at year end:

Current Fund
Dr. Unexpended Balance X-119XXX-XXXXX-0560
Cr. Expenditure Account X-XXXXXX-XXXXX-X-9981

For this transaction, the transaction code 0560 will correspond to transaction code 3XXX under section VI.B.2. above.

VII. OBJECT CODES AND CORPORATE FINANCIAL SYSTEM

Many of the object codes mentioned in this chapter (5310, 5320, 5410, 5420, 9060, 9065, 9070, 9960, 9965, and 9970) are optional codes and are not used for consolidation purposes at the Office of the President. The campus may use these codes for local information but must convert them to match the codes listed in Accounting Manual chapter A-115-2 (5300, 5400, 5600, 5700, and 9000) before transmitting associated data to the Corporate Financial System (CFS). The campus may also use other codes (not mentioned in this chapter) for local purposes but must convert them to the codes listed in Accounting Manual chapter A-115-2. The codes listed in A-115-2 are the only acceptable codes. If the above mentioned codes are used to process and transmit financial data to CFS without conversion, an error message will appear. The Office of the President policy is to keep the list of object codes on CFS to a minimum while providing the desired information. If more detailed information is needed at the CFS level, these and other codes will be added to the A-115-2 chapter.

VIII. REFINANCING OF EQUIPMENT

There is no change in the equipment inventory system acquisition code when equipment is refinanced. When equipment, which was previously purchased by the campus and entered into the equipment inventory system with the acquisition code "31" (purchase order), is later used as collateral for a lease, the acquisition code should not be changed.

IX. RESPONSIBILITIES

The Campus Controllers have overall responsibility for ensuring the necessary accounting entries are made in accordance with this Accounting Manual chapter and for submitting the completed Report on Leases to the Corporate Accounting Office in accordance with the Fiscal Closing Instructions. Some of the lease information may require coordination with the purchasing department.

X. REFERENCES

Accounting Manual chapter:

- A-115-2 Accounting Codes: General Ledger
- A-115-3 Accounting Codes: Transaction Codes for Fund Balances Accounts
- P-415-3 Investment in Plant - Capitalization and Elimination in Current Funds
- P-415-8 Plant Accounting: Unexpended Plant Funds

Business and Finance Bulletin:

- BUS-29 Management and Control of University Equipment
- BUS-43 Materiel Management

Bylaws and Standing Orders of The Regents: Bylaw 21.3 and standing Order 100.4.

Director Donald L. Alter, Memorandum to Accounting Officers on Accounting for Leases, February 8, 1988.

Director Donald L. Alter, Memorandum to Accounting Officers on Revisions to Accounting Manual chapter L-217-11, May 19, 1992.

Historical note: Original Accounting Manual first issued 8/1/80; first revision 3/1/84, second revision 8/1/91. Current revisions 12/1/92 and 6/30/04; analyst--Helena Leung.

EXHIBIT A DIAGRAM FOR REQUIRED ELEMENTS OF A CAPITAL LEASE

