

Volume No. 1—Policies and Procedures	TOPIC NO	31215 – Cardinal
Section No. 31200—Lease Accounting	TOPIC	LAS Transactions
	DATE	August 2015

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Overview

Introduction This topic provides guidance about entering into lease agreements and ensuring proper classification of leases and handling leasehold improvements. All financial information related to property, plant and equipment lease agreements must be properly recorded and accounted for on the books of the Commonwealth with appropriate reporting and disclosure in agency and Commonwealth financial statements in accordance with generally accepted accounting principles (GAAP). The following procedures assist to ensure compliance with these requirements.

Policy

General Agencies must ensure that proper determination is made as to whether an agreement to acquire property, plant or equipment is a lease. If it is a lease, proper classification must be determined in order to accurately record, account for and report on the acquired asset. If it is not a lease, CAPP – Cardinal Section No. 31200, *Lease Accounting*, is not applicable. Instead, CAPP – Cardinal Sections 30100 thru 31100 covering the Fixed Asset Accounting and Control System (FAACS) would be applicable.

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Procedures

Installment Purchases

If title passes upon signature, the agreement is an installment purchase and should not be recorded in the Lease Accounting System (LAS). If the asset passes the FAACS input requirements (see CAPP – Cardinal Topic No. 30305, *Capitalized or Controlled Assets*) it should be recorded in FAACS.

Lease Agreement

All lease agreements should be recorded in LAS whenever the following conditions are met.

The lease agreement contains:

- **an initial non-cancelable term of one year or more, and**
- **total lease payments that are greater than or equal to \$5,000 over the entire lease term, or**
- **the Fair Market Value of the lease is \$5,000 or more.**

If the first condition and either of the last two conditions are met, the lease must be recorded in LAS.

Once an agreement has been determined to be a lease, include the following information in the lease agreement to properly classify the lease in LAS. (See CAPP – Cardinal Topic No. 70605, *LAS Input Documents*: these are no longer required but may be helpful in completing lease documentation for the online data entry.)

Required Lease Information

- **Fair Market Value of the Leased Asset:** See Definitions in CAPP – Cardinal Topic No. 31205, *Introduction*. For new leased assets, this value is typically the purchase price and may be obtained from the vendor or may be independently verified by the agency using the following sources:

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Procedures, Continued

Agency	Item to be Valued
Virginia Information Technologies Agency (VITA)	Electronic data processing equipment
Department of General Services, Division of Engineering and Buildings	Real Estate
Department of General Services, Division of Purchases and Supply, or independent research using state contracts or a “web-search.”	All other items

- **Total Economic Life:** See Definition CAPP – Cardinal Topic No. 31205, *Introduction*.
- **Estimated Remaining Economic Life:** See Definition CAPP – Cardinal Topic No. 31205, *Introduction*.
- **Year Constructed:** This field is optional and indicates the actual year that the construction was completed if known. Helpful in determining Remaining Economic Life.
- **Incremental Borrowing Rate:** See Definition CAPP – Cardinal Topic No. 31205, *Introduction*. LAS uses the current prime rate as the “incremental borrowing rate.”
- **Executory Costs:** See Definition CAPP – Cardinal Topic No. 31205—*Introduction*.
- **Salvage Value:** See Definition CAPP – Cardinal Topic No. 31205, *Introduction*.
- **Guaranteed or Unguaranteed Residual Value:** See Definition CAPP – Cardinal Topic No. 31205, *Introduction*.
- The lease term (number of payments), the payment amount and frequency of the lease payments.
- Any additional terms and conditions regarding renewals or penalties.
- Any bargain purchase options which transfer (or reasonably ensure transfer) of ownership, of the asset.

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Procedures, Continued

Is It a Capital or Operating Lease?

Lease Classification

Leases are classified as either operating or capital leases from the lessee's standpoint. Whether the lease is operating or capital depends on the following conditions:

- Will the agency (lessee) using the asset obtain ownership of the asset during or at the end of the lease term?
- Will the agency make enough payments to have, in effect, purchased the asset, or
- Will the asset be used for most of its economic/useful life?

See Lease Classification in CAPP – Cardinal Topic No. 31210, *Economic Analysis* for the technical requirements.

Operating Lease

If the agency is only using the asset for a short period of time, and will not take ownership or use up most of the asset's worth, then the lease is classified as an operating lease. See Lease Classification in CAPP – Cardinal Topic No. 31210, *Economic Analysis* for the technical requirements.

Capital Lease

If the asset is essentially being paid for or used for most of its economic life, then the lease is classified as a capital lease whether the agency will actually acquire ownership or not. A capital lease is a lease that meets any one of the four tests set forth by the Financial Accounting Standards Board.

Lease Analysis

Tests to determine lease classification are defined in CAPP – Cardinal Topic No. 31210, *Economic Analysis*.

Agencies should perform an analysis of each prospective lease to determine if the lease is (1) operating or (2) capital in accordance with **GASB Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements**. Contact DOA for assistance with this analysis as needed.

A lease involving equipment with an estimated fair market value of less than \$50,000 will be considered an operating lease by DOA. Equipment valued at \$50,000 and above will be subject to all four tests, unless the lease is for an asset in the last 25% of its economic life.

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Procedures, Continued

A lease involving a building with an estimated fair market value of less than \$100,000 will be considered an operating lease by DOA. Buildings valued at \$100,000 and above will be subject to all four tests, unless the lease is for an asset in the last 25% of its economic life.

Leases involving Title Transfer or Bargain Purchase Option are capital regardless of the fair market value or the remaining economic life of the asset.

Lessor’s Lease Types

When the Commonwealth (Agency) is the Lessor, a lease can either be a

1. direct financing lease,
 2. sales-type lease, or
 3. operating lease.
- A direct financing lease is a capital lease. The lease passes at least one of the four classification tests. For simplification, a direct financing lease is referred to as a capital lease throughout this manual.
 - A sales-type lease is also a capital lease. It differs from the direct financing lease in that the lease gives rise to a profit on the transaction (beyond interest income) to the lessor. Since the State does not incur profit when it is the lessor, this type of lease should not occur.
 - An operating lease does not meet any of the four criteria used to classify a lease as being capital. (See CAPP – Cardinal Topic No. 31205, *Introduction*.)

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Procedures, Continued

Leasehold Improvements Must Be Capitalized

Permanent improvements to leased assets are considered an integral part of the leased property and must be capitalized in FAACS.

Such improvements represent items that cannot be removed without substantially damaging or requiring substantial repair to the leased asset. Therefore, the capitalized leasehold improvement cost should be depreciated over either the (1) term of the lease or (2) service life of the improvement, whichever is shorter.

To determine lease term for depreciating capitalized leasehold improvements, renewal or option-year provisions are to be ignored.

Recording Leasehold Improvements in FAACS

Leasehold improvements are entered into FAACS using special nomenclature codes for leasehold improvements. Capital assets merely located on leased property and not permanently installed should be recorded in FAACS using the FAACS nomenclature code to reflect the assets class (See CAPP – Cardinal Topic No. 30315, *Nomenclature Codes.*)

Cardinal Transition Entries

Currently, FAACS interfaces with CARS and there is an interface with Cardinal under development. Each month, FAACS generates an entry to record asset activity in CARS. In order to replicate these asset entries in Cardinal, Wave 1 agencies will need to manually create a General Ledger Journal. The GL Journal should be recorded in Cardinal prior to the close of the same accounting period as was used in CARS. This will be an ongoing activity for Wave 1 agencies until the interface from FAACS to Cardinal is implemented in February 2016.

Refer to the “SW GL332 Crosswalk from FAACS Transaction Codes to Cardinal Accounts” Job Aid for further information regarding the recording of FAACS activity in Cardinal. The Job Aid can be found on the Cardinal Project website.

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Internal Control

General

Each agency and institution should implement cost-beneficial internal control procedures to ensure that:

- All potential agreements to acquire property, plant and equipment are properly evaluated to determine if the transaction is truly a lease.
 - All leases are properly classified as either operating or capital.
 - All leasehold improvements are properly evaluated for inclusion in FAACS.
-

Records Retention

General

Fiscal records related to managing leases should be retained for a period of 2 years plus current fiscal year, or until audited, whichever is greater. However, for pending, ongoing, or unresolved litigation, audits or claims, retain documentation until completion, resolution, or negotiation of settlements.

Destruction of records must be in accordance with policies and procedures of the Records Management Section, The Library of Virginia.

DOA Contact

Contact

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Subject Cross References

References

CAPP – Cardinal Topic No. 30305, *Capitalized or Controlled Assets*

CAPP – Cardinal Topic No. 30315, *Nomenclature Codes*

CAPP – Cardinal Topic No. 31205, *Introduction*

CAPP – Cardinal Topic No. 31220, *LAS Reporting*

CAPP Topic No. 70605, *LAS Input Documents*

Suggested Job Aid The following can be found on the Cardinal Website, under Statewide Toolbox – Job Aids:

SW GL332 Crosswalk from FAACS Transaction Codes to Cardinal Accounts

Additional job aids and training materials may be available on the Cardinal website.

Please note: The Cardinal job aids, training materials and forms on the Cardinal website are not policy of the Department of Accounts and are not part of the Commonwealth Accounting Policies and Procedures Manual (CAPP).
