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Overview

Introduction

The purpose of this topic is to provide guidance in the performance of an economic analysis for leases.

The Department of Accounts (DOA) maintains a technical understanding of lease analysis methods and performs an analysis for agencies when requested. Agencies are encouraged to consult with DOA if questions arise or to seek an opinion as to the adequacy of the analytical approach they intend to utilize.

Guidelines summarizing the economic analysis process are listed below.

Policy

General

Agencies must determine if the terms of a lease are favorable to the Commonwealth.

One method for making this determination is the performance of an economic analysis, when deemed appropriate by the agency, based upon materiality of the potential acquisition.

When undertaking an economic analysis, it is suggested that the following be considered:

- Cost benefit of preparing the analysis,
- Internal procedures showing the conditions under which such an analysis will be made and,
- Documentation maintained that is related to the analysis.

Exception

An economic analysis is not required for equipment financed under the Treasury Board's Financing Program or the Higher Education Equipment Trust Fund administered by the Virginia College Building Authority (VCBA).

Also, an analysis is not required when routinely entering into leases for office space since the Bureau of Real Estate Services at the Department of General Services coordinates these leases.
Procedures

Lease Classification

The first step in the lease analysis process is to determine the classification of the proposed lease. The following should be applied.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Lease Types</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title Transfer Classification</td>
<td>Leases where the title passes to the lessee at the end of the lease term and does not contain a termination clause are considered financed purchases of the underlying lease asset.</td>
</tr>
<tr>
<td>Short-term Lease Classification</td>
<td>A short-term lease is a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised.</td>
</tr>
<tr>
<td>Long-term Classification</td>
<td>Long-term leases are leases having a lease term of greater than 12 months. Long-term leases are required to be reported in the financial statement note disclosures for leases under GASBS No. 87.</td>
</tr>
</tbody>
</table>

Note: For statewide reporting, DOA has established a reporting threshold of $50,000 for short-term leases. Therefore, by default, any lease that has a lease asset value of less than $50,000 will be classified as a short-term lease in LAS 87. The lease asset value is used in these computations as this amount will always be equal to, or greater than, the present value of the lease payment stream.
Procedures, Continued

Long-term Lease: Acquisition Methods

When the proposed lease is classified as a long-term lease, additional steps should be performed to determine the best method of acquisition. Determine if:

- title passes to the lessee at the end of the lease and
- the interest rate is reasonable in order to determine the economic feasibility of the lease.

<table>
<thead>
<tr>
<th>Preferred Methods of Acquisition</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase—Cash</td>
<td>Using current cash and appropriation if the agency has sufficient cash and appropriation to purchase, and the cash is not required for near-term needs</td>
</tr>
<tr>
<td>Purchase—Installment</td>
<td>Using an installment purchase plan wherein title passes immediately and the interest rate is reasonable.</td>
</tr>
<tr>
<td>Long-term Lease</td>
<td>Title does not pass to the lessee. The leased asset is returned to the lessor at the end of the lease term, and the interest rate is reasonable.</td>
</tr>
</tbody>
</table>

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Procedures, Continued

Long-term Lease: Evaluation

Determine if the present value of the lease payments at the lessor’s stated rate of interest contained in the lease contract compares favorably with other available financing rates and the estimated asset value. You can determine this by:

- Inputting the lease into the on-line LAS 87 and allowing the system to calculate the various lease asset and lease liability schedules for review.
- Using another automated software product such as Excel.

Consider the following factors:

- Minimum Lease Payments
- Executory Costs
- Estimated Value of the Leased Asset

See CAPP Topic No. 31205-LAS 87, Introduction, for detailed definitions.

The lessor’s interest rate stated in the lease contract should also be compared to the:

- Published Prime Interest Rate (rate published at the time the proposed lease is under consideration), or
- Treasury Board Financing Program Rate.

For the proposed lease or installment purchase to be considered favorable, the interest rate contained in the lease contract should **not exceed** either of these rates. The on-line LAS 87 will perform the necessary calculations to determine the lease asset and lease liability amounts.

*Continued on next page*
Procedures, Continued

Long-term Lease: Approval Process

If an agency is planning to pursue a long-term lease contract, the agency is responsible for performing appropriate lease analysis prior to entering into a lease contract. Agency fiscal personnel should review the current Appropriation Act, Part 4 - General Provisions, to familiarize themselves with the legislative requirements. The fiscal personnel should then contact DOA to discuss the proposed lease situation. Since each potential lease contract will be unique, DOA will assist the agency in identifying the information required to be submitted to DOA on a case-by-case basis. In most instances, agencies or higher education institutions must obtain Treasury Board approval before entering into a long-term lease contract.

Unfavorable Lease Terms

If the above analysis indicates the terms of the proposed lease are unfavorable, i.e., stated interest rate is high and/or title does not pass, the agency may elect to proceed with the lease contract. In such cases, this requires approval in writing from the agency head or other responsible person to whom this authority has been delegated.
Internal Control

General

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

- Procedures exist indicating when an economic analysis should be performed.
- Every effort is made to obtain favorable rates of interest in the lease or installment purchase.
- Agency head or designee approval is obtained for all leases shown to have unfavorable terms.
- Interest rates are compared to incremental borrowing rates and Treasury Board Financing Program rates.
- Treasury Board approval is obtained for alternative financing arrangements for items exceeding prescribed limits.
Records Retention

General

Records should be maintained for a period of at least three years or longer, if necessary, to be in compliance with policies established by the Records Management Section, The Library of Virginia. The retention period generally starts at the close of the fiscal period.

For pending, ongoing or unresolved litigation, audits or claims, retain documentation until completion, resolution or negotiation of settlements and retain according to standard schedules. Provide for the periodic destruction of records not subject to permanent deposit in accordance with policies and procedures established by the Records Management Section, Virginia State Library and Archives.

DOA Contact

Contact

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✉️ las@doa.virginia.gov

Subject Cross References

References

CAPP Topic No. 31205-LAS 87, Introduction

CAPP Topic No. 70605-LAS 87, Input Documents