

CITY OF FOLEY
CAPITAL & OPERATING LEASE POLICY

Sec. 1 Requirement.

The Financial Accounting Standards Board (FASB) established principles for lease accounting in its Statement 13, *Accounting for Leases*, and its numerous amendments. These statements specify the appropriate accounting for leases through their classification as either capital or operating. Governmental Accounting Standards Board (GASB) codification provides that FASB 13 should be the guidelines for accounting and financial reporting for lease agreements, except for operating leases with scheduled rent increases. Scheduled rent increases are increases that are fixed by contract.

Sec. 2 Purpose.

This Accounting Policy is intended to differentiate the appropriate classification of leases and document authoritative literature for the accounting treatment for leases by the lessee.

Sec. 3 Classification of Leases by Lessees - Overview.

3.1 Definitions. A lease is a financing transaction called a capital lease if it meets any one of four specified criteria; if not, it is an operating lease. Capital leases are treated as the acquisition of assets and the incurrence of obligations by the lessee. Operating leases are treated as current operating expenses.

3.2 Income Statement. Whether leases are treated as capital or operating leases affects the income statement as well as the balance sheet. Over the life of a lease, total expenses are equal regardless of the accounting treatment of a lease. If the lease is capitalized, total expenses comprise interest and depreciation. The total of these equals the total amount of rental payments, which would comprise rent expense if not capitalized. There is, however, a timing difference between lease capitalization and operating lease treatment but it is usually not significant.

3.3 Balance Sheet. The greater difference between capital leases and operating leases is the impact each has on the balance sheet. A capital lease adds to both the asset and liability side of the balance sheet; operating leases do not affect the balance sheet at all.

3.4 Capital Leases.

(a) A capital lease must meet one or more of the following criteria:

- i. the lease transfers ownership of the property to the lessee by the end of the lease term;
- ii. the lease contains a bargain purchase option;

iii. the lease term is equal to 75% or more of the estimated economic life of the leased property. However, 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; and

iv. the present value of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90% of the excess of the fair value of the leased property to the lessor.

(b) The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value of the minimum lease payments using his incremental borrowing rate, unless it is practicable for him to learn the implicit rate computed by the lessor and the implicit rate is less than the lessee's incremental borrowing rate. However, if the amount exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value.

(c) The capitalized leased asset should be amortized over the term of the lease if the term is shorter than the useful life of the asset, unless the lease provided for transfer of title or includes a bargain purchase option.

(d) During the term of the lease, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the lease obligation.

(e) When leasing land, the lease is classified as an operating lease unless it provides for transfer of title or includes a bargain purchase option.

3.5 Operating Leases.

(a) If the lease does not meet the criteria for classification as a capital lease, then it shall be classified as an operating lease.

(b) Transactions arising from operating leases with scheduled rent increases should be measured based on the terms of the lease contract when the pattern of the payment requirements, including the increases, is systematic and rational. The following are examples of payment schedules that are considered systematic and rational:

i. lease agreements specify scheduled rent increases over the lease term that are intended to cover (and are reasonably associated with) economic factors relating to the property, such as the anticipated effects of property value appreciation or increases in costs due to factors such as inflation; or

ii. lease payments are required to be made on a basis that represents the time pattern in which the leased property is available for the use of the lessee.

(c) In those cases when an operating lease with scheduled rent increases contains payment requirements in a particular year or years that are artificially low compared to earlier or later payment requirements, the operating lease transaction should be measured using one of the following methods:

- i. the operating lease transactions may be measured on a straight-line basis over the lease term; or
- ii. the operating lease transactions may be measured based on the estimated fair value of the rental. The implicit financing by the lessor of the lessee's cash flow should be accounted for using the interest method. That is, interest should be calculated for each period so that it results in a constant rate of interest over the lease term on the period's outstanding accrued lease receivable or payable. (Note: If the fair value of the rental is not reasonably estimable, the operating lease transactions should be measured on a straight-line basis over the lease term.)

Definitions

Bargain Purchase Option - provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair [market] value of the property at the date the option becomes exercisable, that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Bargain Renewal Option - provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable, that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Estimated Residual Value of Leased Asset - the estimated fair [market] value of the leased [asset] at the end of the lease term.

Fair [Market] Value of the Leased Property - the price for which the property could be sold in an arm's length transaction between unrelated parties.

Interest Rate Implicit in the Lease - the discount rate that, when applied to [a] the minimum lease payments... excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and [b] the unguaranteed residual value ...accruing to the benefit of the lessor, causes the aggregate present value at the beginning of the lease term to be equal to the fair [i.e., market] value of the leased property...at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him.

Lease Term - the fixed noncancelable term of the lease plus [a] all periods, if any, covered by bargain renewal options...and [b] all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option ...is exercisable; ...however, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable.

Lessee's Incremental Borrowing Rate - the rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

Minimum Lease Payments - From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

- (a) The minimum rental payments over the lease term...
- (b) Any guarantee by the lessee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property...
- (c) Any payment... for failure to renew or extend the lease at the expiration of the lease term.