

# STATE CONTROLLER POLICY

## LEASE CLASSIFICATION

### 1) Definitions

- a. **Capital Lease.** CRS 24-30-201(l) defines capital lease as defined in generally accepted accounting principles issued by the governmental accounting standards board that the controller prescribes for the state as specified in section 24-30-202(12).
- b. **Fair Value of Leased Property.** The price for which the property could be sold in an arm's length transaction between unrelated parties. FAS 13, paragraph 5c.
- c. **Lease.** Under Financial Accounting Standard (FAS) 13, a lease is an agreement conveying the right to use property, plant, and equipment (PP&E) for a stated period of time.
- d. **Lease Purchase Agreement.** CRS 24-82-801(4) defines lease purchase agreement as a capital lease as defined in generally accepted accounting principles issued by the governmental accounting standards board that the controller prescribes for the state as specified in section 24-30-202(12). A lease purchase agreement has the same meaning as a capital lease, which is defined in generally accepted accounting principles.
- e. **Lessee 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. FAS 13, paragraph 5l. Use the Treasurer's pooled cash earnings rate, not the lessor's rate.
- f. **Minimum lease payments.** The payments that the lessee is obligated to make or can be required to make in connection with the leased property. FAS 13, paragraph 5j. Minimum lease payments include rent for the equipment, "executory costs" made to the lessor (e.g. maintenance, insurance, or taxes), the bargain purchase option (which allows the lessee to buy the asset at a predetermined price below fair value), guaranteed residual value (a type of insurance protecting the lessor against an unexpected decline in the value of the asset), and any penalties for failing to renew or extend the lease.

### 2) Lease Classification Under FAS 13

- a. **Generally Accepted Accounting Principles.** The State of Colorado shall use generally accepted accounting principles – FAS 13 to determine the classification of a lease. FAS 13 classifies leases as either operating or capital. Operating leases do not have characteristics of ownership and minimum lease payments are expensed or expensed. Capital leases have characteristics of ownership and the related assets are capitalized and depreciated over the expected useful life of the asset.
- b. **Capital Lease.** Under FAS 13, a lease is classified as a capital lease if, at its inception, it meets *any one* of the following four criteria:
  - i. **Ownership Transfer.** The lease transfers ownership of the property to the lessee by the end of the lease term.
  - ii. **Bargain Purchase Option.** The lease contains a bargain purchase option. This is defined as, "*A provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable and that exercise of the option appears, at the inception of the lease, to be reasonably assured.*" FAS 13, paragraph 5d.
  - iii. **75% Economic Life.** The lease term is equal to 75 percent or more of the estimated economic life of the leased property. The lease term is defined as the "*fixed non-*

# STATE CONTROLLER POLICY

*cancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options.” FAS 13, paragraph 5(f).*

- iv. **Present Value-90% Fair Value.** The present value at the beginning of the lease term 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 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by lessor.
- c. **Operating Lease.** Under FAS 13, A lease is classified as an operating lease if, at its inception, it does not meet any one of the four criteria in §2b above.

## 3) Lease Modifications

- a. **Revision to Original Lease** – If at any time the State and the lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under §2 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered a new agreement over its term.
- b. **New Agreement** - As a new agreement, State agencies and institutions of higher education shall apply the criteria in §2 to classify the lease modification.

## 4) Factors other than FAS 13 to determine whether a lease is Operating or Capital

- a. **Structuring the transaction** - State agencies and institutions of higher education shall use business judgment to structure the transaction so that the lease provides the best value to the State. The best value could be either an operating or capital lease depending on a number of factors:
  - i. **Factors favoring operating lease** – high technology, rapid change, short life, short- term use, financing period that is less than the asset’s useful life. Examples include copiers, office equipment, computer equipment, and buildings where the State intends to occupy for the short-term.
  - ii. **Factors favoring capital lease** – slow rate of technological or usage change, expected long asset useful life, long-term use, and financing period that approximates the asset’s life. Examples include production equipment and buildings where the State intends to occupy for the long-term.
- b. **Uncertainty** - If there is uncertainty about the classification of a lease, the key question to ask is whether the lessee (State) has taken on the risks and benefits of ownership.

## 5) Appropriation Required.

- a. **Real Property.** Lease purchase agreements (capital leases) for real property with total payments greater than \$500,000 shall be specifically authorized by a special bill approved by the General Assembly.
- b. **Personal Property.** Lease purchase agreements (capital leases) for personal property with total payments greater than \$500,000 shall be specifically authorized by an annual general appropriation act, supplemental appropriation act, or special bill approved by the General Assembly.
- c. **Annual Rentals.** Rentals subsequent to approval in §4a and §4b may be made from the capital construction or operating section of an annual general appropriation act or supplemental appropriation act.

# STATE CONTROLLER POLICY

- 6) **Exception to Appropriation** – The following are excluded from §4 above: Colorado Department of Transportation, Institutions of Higher Education, and State Treasurer.
- 7) **State Controller Approval** – The State Controller shall approve all lease purchase agreements with total payments greater than \$500,000. In situations where a lease may be classified as either operating or capital, the agency should have the Office of the State Controller review the classification analysis.
- 8) **Issuance of Instruments**
- a. Lease purchase agreements may provide for issuance of instruments evidencing rights to receive rentals and other payment made by the state, but only if the payments are made subject to annual appropriation.
  - b. Lease purchase agreements shall not include any evidence of indebtedness of the State.
- 9) **Accounting for Leases**
- a. **Operating Leases.** For operating leases, rent is treated as an operating expense/expenditure, which is recognized in financial statements over the time the asset is used. The leased asset and lease liabilities are not recognized in the accounts or the financial statements. FAS 13, paragraph 15.
  - b. **Capital Leases.** For capital leases, the related assets are reported in the accounts and the financial statements as if they had been purchased. The assets and their accompanying liabilities are capitalized either by recognizing the present value of the minimum lease payments, or the value of the leased assets, whichever is the lower. The leased asset is depreciated in the same way as if the asset had been purchased, while its associated liabilities decrease as the lease payments occur. FAS 13, paragraph 10.
  - c. **Fiscal Procedures Manual.** See the Fiscal Procedures Manual for further information on the accounting for leases.

---

David J. McDermott, CPA  
State Controller