



State of Arizona Accounting Manual

Topic 25 Long-lived Resources
Section 45 Capital Leases

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INTRODUCTION

One way of acquired the use or ownership of property is by way of capital lease.

Leases are classified as either capital leases or operating leases. If the lease results in the acquisition of a capital asset (a long-lived resource with a cost that exceeds the applicable capitalization threshold) both the asset and the indebtedness to be recognized with respect to the lease must be recorded on the balance sheet. The criteria for making this determination are outlined below.

POLICY & PROCEDURES

1. A lease is a capital lease when it results in the acquisition of a capital asset and any one of the following four criteria is met:
 - 1.1. Title or ownership of the asset is transferred to the State at the end of the lease.
 - 1.2. The lease contains a bargain purchase option.
 - 1.3. The term of the lease is equal to seventy-five percent (75%) or more of the estimated useful life of the leased property. (This criterion does not apply if the beginning of the lease term falls within the last twenty-five percent (25%) of the total useful life of the capital asset, including earlier years of use.)
 - 1.4. The present value of the sum of the minimum future lease payments at the inception of the lease, excluding executory costs, equals at least 90% of the fair market value of the leased property. (This criterion does not apply if the beginning of the lease term falls within the last twenty-five percent (25%) of the total useful life of the capital asset, including earlier years of use.)
2. Leases that do not satisfy any one of the four criteria set forth above are operating leases.
 - 2.1. An operating lease results not in ownership but merely the temporary possession and use of the resource to which the lease pertains.
 - 2.2. Disbursements related to operating leases are to be treated as expenses in the period in with they are made.
 - 2.3. An asset in the possession of an agency under the terms of an operating lease:

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- 2.3.1. Should be identified and tracked to ensure it is properly safeguarded.
- 2.3.2. Should not be treated as a capital asset in the FAM.
3. The cost of a capital asset acquired under the terms of a capital lease equals the sum of the ancillary costs added to the sum of the present values of the minimum future lease payments (except for executory costs included in the lease payments) plus any prepayments or down payments that apply. When recognized—as is true when the asset is acquired by a proprietary fund—the initial indebtedness incurred under a capital lease is equal to the cost of the leased capital asset.
4. An agency entering into a capital lease must send a copy of the lease agreement—complete with payment and amortization schedules—to the GAO at or before the time the first payment is made.
5. Each agency is required to record all of its capital lease agreements when such agreements result in a capital asset whose cost exceeds its relevant capitalization threshold in FAM. The agency is responsible to ensure that any lease data in FAM is accurate and that the lease related account balances—asset, liability, imputed interest expense, principal reduction—in the general ledger are properly recorded and maintained.
6. It is not uncommon under such arrangements for a lessor, recognizing the true nature of the arrangement, to include an amortization schedule with the other lease documents.
7. FAM has the ability of importing and using amortization schedules that are provided by the lessor or created by the lessee to appropriately allocate each lease payment's principal and interest components.
8. An agency may compute the interest and principal portions of the sum of capital lease payments made during the year and make the appropriate adjusting entries at each fiscal year's end.
9. Agencies are encouraged to contact the GAO for assistance in computing or importing amortization schedules.
10. In FAM, capital assets acquired by capital lease are to be recorded as having been acquired by the acquisition method "LEAS."
11. Agencies are prohibited from using installment purchase agreements and similar debt instruments to finance acquisitions.
12. All capital leases and related financial arrangements must contain a provision that exempts the State from any liability (beyond recovery of the underlying leased property) should funds not be available or not have been appropriated to make scheduled payments (i.e., all such agreements must contain a fiscal funding out clause).