UC GUIDELINES ON CAPITAL LEASES
(as they pertain to real estate)

It is the requirement of The Regents that leases (The Regents as tenant) be capitalized if they meet certain standard accounting criteria. These criteria are contained in the Financial Accounting Standards Statement 13 (FAS 13) and are summarized in the University Accounting Manual under Chapter L-217-11, Section IV and below.

Capital leases take on many of the same characteristics as other forms of University issued debt financing. Therefore, in order to avoid **debt by accident**, it is essential that campus real estate personnel recognize the characteristics that distinguish a capital lease from an operating lease. Any leases meeting the capital lease criteria described below must be considered as capital (rather than operating) leases. Following are the elements used to judge whether a lease is a capital lease and some specific considerations/ interpretations that apply to the most complex of the criteria—the relationship between the present value of lease payments and the fair market value of the property.

Capital Lease Criteria

A lease must be considered a capital lease if it contains all of the following elements – A. through C. (see especially the four conditions in item A.):

A. The lease meets <u>one or more</u> of the following four criteria—

   1) The lease transfers ownership of the property to the lessee by the end of the lease term; or,

   2) The lease contains a bargain purchase option, i.e. one sufficiently below the expected fair market value of the property to reasonably assure its exercise (All leases with a bargain purchase option for hospital, auxiliary, or service enterprises where there is a likelihood that the option will be exercised should be considered as capital leases.); or,

   3) The lease term is equal to 75% or more of the estimated economic life of the leased property (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.); or,

   4) The present value of rental or other minimum lease payments equals or exceeds 90% of the fair value of the leased property less any investment tax credit retained by the landlord; and,

B. The leased asset has a current market value (current cash purchase price) of $100,000 or more; and,

C. The lease is non-cancelable (prior to the end of the lease term); a lease is considered non-cancelable if it ceases to be in force

1) Only upon the occurrence of some remote contingency (cancellation of funding); or,

2) Only with the permission of the landlord; or,

3) Only if the tenant enters into a new lease with the same landlord; or

4) Only upon payment by the tenant of a penalty in an amount such that continuation of the lease appears, as at inception, reasonably assured.

Specific Considerations

The four criteria under paragraph A, above, require evaluation of the property, lease term, rent and rights to acquire the property, if any. In particular, the 90% test in A. 4) is of concern in leases with longer terms and/or high rents. This test requires that the total rent payable over the lease term be discounted to present value and be less than 90% of the property's fair market value or be considered a capital lease. In performing this calculation, the following considerations apply:

1. Lease Term: Options to extend the lease may be considered part of the lease term if the rental for those options is potentially less than market rent. Specifically, if it can be projected that the rent provided for in the option would be lower than the fair market rent for the property at the date the option becomes exercisable by an amount sufficient to assure the option would likely be exercised or is otherwise so favorable that its exercise is assured, it must be included in the lease term discounted for the A. 4) evaluation.

2. Rental: All payments that the tenant is obligated to make or can be required to make in connection with the leased property (including the payments for tenant improvements made by the landlord, but excluding "executory" costs such as insurance, maintenance and taxes) must be included as rental. For example, up front cash payments or additional rent to amortize tenant improvements would be included, but operating expense payments, including the component of rent attributable to operating expenses in a gross lease (i.e., base year operating expenses plus pass through expenses) would not be included.

3. Discount Rate: In virtually all cases, the applicable interest rate will be the tenant's incremental borrowing rate, e.g. the rate at which The Regents' most recent bond pool was sold or the rate of a related index (e.g., as of July 2002 this rate would be 5.05%).

In order to avoid **debt by accident**, any lease that may meet the criteria for a capital lease must be thoroughly examined in light of the above considerations and, if appropriate, the structure of the arrangement modified to qualify for operating lease treatment. Real property leases should be capitalized if they contain the above elements. The applicability of the accounting rules in this area can be complex. As needed, RESG will consult with Corporate Accounting and the University's outside auditors. Ultimately, the University's accounting staff and outside auditors make the determination of whether to characterize and book a University lease as a capital rather than an operating lease.