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INFORMATION MEMORANDUM

TO: All Head Start and Early Head Start Agencies and Delegate Agencies

SUBJECT: Accounting and Reporting Capital Leases

INFORMATION:

The Financial Accounting Standards Board (FASB) issued updated guidance on lease accounting (Accounting Standards Update 2016-2). Its purpose is to improve financial reporting about leasing transactions. The guidance affects all Head Start grantees that lease capital assets, such as real estate and equipment.

The recognition, measurement, and presentation of expenses and cash flows arising from a lease will primarily depend on its classification as a capital (finance) or operating lease. It is critical that grantees account for and charge costs for leases based on their proper classification. Failure to comply with Head Start facilities requirements and fiscal regulations defining and limiting allowable lease costs may result in substantial disallowances.

Capital Lease Defined

A lease must be classified as a capital lease if it meets any one of the four specified criteria that follow. If it does not meet these criteria, it is an operating lease.

1. The lease transfers ownership of the property to the lessee (grantee) by the end of the lease term.
2. The lease contains a bargain purchase option to allow the lessee to purchase the property at a price below its expected fair market value at the time the option is exercised.

3. The lease term is equal to 75% or more of the estimated economic life of the leased property.
4. The minimum lease payments over the term of the lease equal or exceed 90% of the fair market value of the leased property at the beginning of the lease.

A detailed explanation of these criteria is included at Page 8 of Financial Accounting Standard 13, Accounting for Leases.

Capital Leases

The Uniform Administrative Requirements, Cost Principles, and Audit Requirements for U.S. Department of Health and Human Services Awards (the Uniform Guidance) at 45 CFR §75.465(c)(5) limits the amount of rental costs for leases which are required to be treated as capital leases under generally accepted accounting principles (GAAP), and less-than-arms-length leases. Rental costs are limited to the amount that would be allowed had the non-federal entity (grantee) purchased the property on the date the lease agreement was signed. This amount includes expenses such as depreciation, maintenance, taxes, and insurance.

The Head Start Program Performance Standards (HSPPS) include the use of grant funds to make a payment under a capital lease agreement in the definition of *Purchase* (45 CFR §1305.2). Consequently, capital leases must be submitted for approval prior to execution in accordance with 45 CFR Part 1303 Subpart E in the same manner as other facilities purchase arrangements and encumbrances. Use of Head Start funds to make payments under a capital lease triggers the requirement to file a notice of federal interest as described in 45 CFR §1303.46(b).

Information regarding capital leases must also be included in the grantee's Annual Real Property Report on SF-429 with Attachment A.

Operating Leases

Rental costs under arms-length operating leases are allowable if they are reasonable and do not exceed rental costs of comparable property considering local market conditions, availability of alternatives, and the type, life expectancy, condition, and value of the property leased. If operating lease payments are increased beyond fair market rental value to allow a landlord to recover the at least 90% of the cost of major renovations to leased property, the lease arrangement is a capital lease. See Capital Lease Defined no. 4 above. The major renovation is subject to prior approval, compliance with 45 CFR Part 1303 Subpart E, and federal interest results.

Capital Lease Payments

Grantees are not prohibited from entering into capital leases. However, grantees must properly categorize, account for, and receive prior approval for such leases in accordance with GAAP, the Uniform Guidance, and the HSPPS.

A grantee considering a capital lease arrangement should be aware of the following:

- A capital lease is a purchase arrangement, and an encumbrance, under the HSPPS. It is subject to all of the requirements of 45 CFR Part 1303 Subpart E, including submission of SF-429 with Attachment B (purchase) and Attachment C (encumbrance) in the GrantSolutions Online Data Collection System (OLDC), and prior approval by the Administration for Children and Families. Grantees are also required to file of a notice of federal interest to protect federal funds used to make capital lease payments.

- Unless a capital lease receives prior written approval under 45 CFR Part 1303 Subpart E, the grantee may only charge its Head Start award for amounts that would be allowed had the grantee held title to the leased facility; expenses such as depreciation, maintenance, taxes (if applicable to the grantee); and insurance.

- In the event that failure to comply with regulations applicable to capital leases results in unallowable charges to the Head Start award, a disallowance may be taken for payments made over the entire term of the capital lease.

Grantees should carefully examine proposed lease arrangement when determining their character as either operating or capital leases to assure compliance with applicable fiscal regulations and avoid potentially significant amounts of disallowed costs.

Thank you for your work on behalf of children and families.

/ Deborah Bergeron /

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Director
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