New Rules on a Government's Accounting for Leases

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Table of Contents

Executive Summary

Under the current authoritative literature, leases are generally reported as operating leases without liability recognition even though the state or local government often is committed to make payments on a long-term basis. Likewise, the lessor records no receivable for its long-term right to receive payments. This changes under Statement No. 87, *Leases*, issued by the Governmental Accounting Standards Board (GASB) in June. Statement 87 establishes a uniform approach to accounting for and reporting leases based on the principle that all leases are, in substance, financings. The approach to accounting for leases is no longer based on one of two classifications of the arrangement—that some leases essentially are financed purchases of the underlying asset (classified as capital leases) and other leases (classified as operating leases) are executory contracts requiring payment as performance occurs.

Elimination of the operating lease category will significantly affect governmental lessee financial statements. Lessor accounting will mirror lessee accounting, with the exclusion of the statement's recognition and measurement requirements for leases of underlying assets held as investments and certain regulated leases, *e.g.*, leases between municipal airports and air carriers. Instead, specific disclosure requirements apply to these agreements.

Overall, the treatment of leases will be comparable to current guidance for capital leases. A lessee government will recognize a lease liability and intangible right-to-use lease asset at the lease term's beginning. Rent expense under today's operating leases will be replaced with interest and amortization expenses. A lessee will recognize interest on the lease liability and amortization on the intangible lease asset over the lease term or, if shorter, the underlying asset's useful life. Because lease transactions under Statement 87 are considered financed purchases of a capital asset, lessees will present the right to use intangible lease asset as a capital asset and a lease liability for the future payments.

A lessor government is required to recognize a lease receivable and a deferred inflow of resources at the lease term's beginning. Lease revenue will be systematically recognized over the lease term with a corresponding reduction in deferred inflow of resources. Interest income on the lease receivable created by the financing arrangement will be recognized using the effective interest method. Lessors will not derecognize the underlying asset or calculate a residual value.

The guidance requires lessees and lessors to disaggregate nonlease (service components) and contracts with multiple lease components. Regular reassessments of amounts recorded by the lessee and lessor as lease liabilities and lease receivables, respectively, are not mandatory, although some circumstances require updates or changes to the amounts recognized.

The new guidance applies to leases of nonfinancial assets, *e.g.*, vehicles, heavy equipment and buildings, and excludes nonexchange transactions, *e.g.*, zero-rent leases, and leases of intangible assets, including patents and software licenses.

For lessees, the current operating lease category (not recognized in the statement of net assets) will be eliminated, along with potential opportunities to structure a lease for the desired financial statement effect. All leases will result in the recognition of interest and amortization expense, and all lease commitments will be recognized as liabilities. This differs from the Financial Accounting Standards Board's (FASB) new Leases guidance, which maintains the operating lease classification and recognition principles (the recognition of rent expense). In the cash flows statement, lease payments will be classified as financing outflows for GASB and operating outflows for FASB entities.

For lessors, derecognition of the underlying asset and calculation of the residual value will not be required, both of which are required under FASB's leases guidance for direct-financing and sales-type leases. GASB is eliminating the direct-financing and sales-type lease categories under Statement 87.

The differences in accounting between FASB and GASB will particularly affect higher education and health care industry sectors, and others in which both FASB and GASB requirements apply or comparability to their for-profit counterparts is important.

The new leases standard requires enhanced disclosure of the longer-term effect of leases on a government's resources. Lessees will disclose future payment commitments, and lessors will disclose the expected revenue stream. Note disclosures will include a general description of the leasing arrangement and the aggregate amount of resource inflows/outflows recognized from lease contracts, including those not included in the measurement of the lease receivable/liability. Additional disclosures regarding the existence of renewal and termination options are not required.

Statement 87 is effective for reporting periods beginning after December 15, 2019 (one year later than proposed in the Exposure Draft), with earlier application encouraged. Adjustments to transition to the new leases guidance should be made based on the remaining lease payments as of the beginning of the implementation period or the beginning of any earlier periods restated. However, lessors should not restate the assets underlying any existing sales-type or direct-financing leases; instead, the residual lease asset at transition would become the carrying value of the underlying asset.

Key Provisions

Definition of a Lease

In Statement 87, a lease is defined as "a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction." A nonfinancial asset is an asset not meeting the definition of a financial asset as defined in Statement No. 72, *Fair Value Measurement and Application*. Examples of nonfinancial underlying assets are buildings, land, vehicles and equipment.

Statement No. 87 replaces the term agreement under current guidance with the term contract to require that a lease—whether written or verbal—is legally enforceable.

The notion of control in the lease definition is applied to the right-to-use asset as the contract specifies. A lessee has obtained control of the right to use the asset if the contract conveys to the lessee the right to determine the underlying asset's nature and manner of use and obtain the underlying asset's present service capacity. The criteria do not limit a lease to contracts that convey "substantially all" of the present service capacity from the underlying asset's use.

Contracts for services are not leases. Contracts conveying the right to use an underlying asset that includes a service component are discussed below in the section "Multiple Lease Components."

Practice Point:

- *Some governmental contracts transfer the right to use an asset for only a nominal amount, e.g., one dollar per year, in exchange for the right to use the underlying asset. The substance of that type of arrangement represents a nonexchange transaction, e.g., a donation or grant, which is within the scope of Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions, and is not within Statement 87's scope.*

  The existing guidance in Statement 33 does not specifically address the right to use nonfinancial assets in nonexchange transactions, e.g., the free use of office space. Such nonexchange transactions are expected to be addressed as part of GASB's project on revenue and expense recognition.

Scope Exclusions

Leases of inventory, other financed purchases where ownership is transferred and supply contracts—such as power purchase agreements that convey access to the assets' outputs, rather than control of the right to use the underlying asset—are excluded from Statement 87's provisions. Contracts that transfer ownership of the underlying asset to the lessee and do not contain a termination option—or a fiscal funding or cancellation clause that is reasonably certain of being exercised—should be accounted for as financed purchases or sales.

The presence of a bargain purchase option in a lease contract is not equivalent to a provision that transfers ownership of the underlying asset.

Certain other scope exclusions in the current leases guidance are carried forward to Statement 87. These include contracts for the rights to explore for or exploit natural resources and biological assets, *e.g.*, oil, gas, minerals and timber, and licensing contracts, *e.g.*, for motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Computer software licensing contracts, contracts pertaining to living plants and animals and service concession arrangements (SCA) also are specifically excluded from Statement 87's scope. The lease-like portion of these arrangements should be addressed with consideration of the transaction in its entirety. For example, preparers would refer to Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, for guidance on accounting for SCAs. Assets under construction and historical works of art are not excluded from Statement 87's scope.

Practice Points:

- *Implementation Guide No. 2015-1 stated that licensing agreements for computer software should not be treated as leases. Because of the unique features and complexities of these transactions, GASB decided to explicitly exclude licensing contracts for computer software from Statement 87. Software licensing contracts are expected to be studied further as part of GASB's separate pre-agenda research activity addressing information technology arrangements, including cloud computing.*
- *Governments may be tempted to treat lease contracts containing a bargain purchase option as a financed purchase or sale. However, even if the lessee is reasonably certain to purchase the underlying asset, the contract is a lease contract requiring recognition of an intangible right-of-use asset and corresponding liability until the option is exercised.*

Leases in which the underlying asset is financed with outstanding conduit debt are excluded from Statement 87's scope, unless the lessor reports both the underlying asset and conduit debt[1].

Lease Term

Assessment of the lease term is performed at lease commencement and begins with the period during which the lessee has a noncancelable right to use the underlying asset. The noncancelable period then is adjusted for periods covered by lessee and lessor options to extend or terminate the lease based on whether it is reasonably certain options to extend will be exercised—and options to terminate will not be exercised—considering all relevant factors.

The threshold of "reasonably certain" essentially retains the threshold of "reasonably assured" in current lease guidance. The requirement to evaluate lessor options from the same threshold perspective as lessee options is based on the premise that both parties' options have the same enforceability if exercised.

Periods for which the lessee **and** the lessor each have an option to cancel the lease without permission from the other party—or if both parties must agree to extend—are cancelable periods excluded from the lease term. As such, rolling month-to-month leases—or leases that continue into a holdover period until a new lease contract is signed—would not be enforceable, and such leases should be excluded from the lease term.

Practice Points:

- *The likelihood of whether lessor-only options might be exercised may be difficult for a lessee to evaluate, and vice versa for lessee-only options. Lessors are encouraged to make an assessment of the lease term based on information received about the lessee's plans, including funding arrangements, during lease negotiations.*
- *Laws and regulations often require inclusion of a fiscal funding or cancellation clause in lease agreements, even though the government, acting in good faith at lease commencement, does not intend or expect to exercise the clause. Lessors would consider the clause in its lease term assessment using the general criteria of whether it is reasonably certain the clause will be exercised. In other words, the clause would affect the lease term only when it is reasonably certain the funds will not be appropriated.*
- *Because governments do not always make decisions solely for economic reasons, all relevant factors should be considered in determining the likelihood of whether an option will be exercised. Such factors may be contract- or market-based, e.g., significant economic incentive to extend or disincentives to terminate the lease considering current market rates, or lessee costs of identifying another suitable underlying asset or returning the asset, underlying asset-based, e.g., extent to which the asset is essential to the lessee's provision of services, government-specific, e.g., history of exercising option to extend or terminate, or a combination thereof.*

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[1] *For purposes of Statement 87, conduit debt is debt issued in the government's name to finance the construction or acquisition of capital assets to be leased, which is secured by the lease payments. Issuers of conduit debt are not required under Interpretation No. 2, Disclosure of Conduit Debt Obligations, to recognize a liability for the debt. Likewise, the facilities constructed or acquired with the debt proceeds generally are not reported in the financial statements of issuers of conduit debt. GASB has initiated separate pre-agenda research to re-examine accounting and financial reporting for conduit debt.*

Reassessment

The lease term should be reassessed when the lessee or lessor exercises an option or elects not to exercise an option contrary to the lease term's initial determination, or when an event specified in the contract that requires a lease extension or termination occurs. Lease terms are not remeasured based on changes in the probability of an event or action occurring.

Short-Term

The guidance in Statement 87 does not apply to short-term leases, defined as leases with a maximum possible term of 12 months or less at lease inception, including options to extend, regardless of their probability of being exercised. The **maximum possible** term for short-term lease assessment assumes that all options to extend would be exercised and includes any notice periods. It inherently excludes all periods cancelable by either the lessee or lessor. For example, rolling month-to-month or year-to-year leases would be considered short-term.

The short-term exception is a requirement rather than an accounting policy election.

For short-term leases, lessees and lessors will only recognize outflows and inflows of resources based on the lease contract's payment provisions (with the recognition of assets and liabilities for payments paid or received before or after the reporting period). No outflow or inflow of resources is recognized during any free-rent (rent holiday) period.

Practice Point:

- *Statement 87 does not include a quantitative threshold exception for lower-value leases. With consideration of general materiality guidelines, if the underlying assets are insignificant—individually and in the aggregate—this statement's provisions may not apply. However, entities establishing a lease capitalization policy similar to that of capital assets are cautioned because the significance of asset capitalization is independent of the assessment of the significance of liability recognition.*

Multiple Lease Components

Within the general principle of materiality, governments should separate contracts into lease and nonlease components or multiple leases if the underlying assets have different lease terms. Lessors and lessees should allocate the contract price to multiple components of a lease by first using individual component prices as stated in the contract, as long as the price allocation does not seem unreasonable based on the contract terms. Professional judgment should be used to determine reasonableness of contract price allocation, maximizing the use of observable information such as readily observable standalone prices.

If a contract does not include separate prices for individual components or if the stated prices appear to be unreasonable, lessors and lessees should use professional judgment to determine their **best estimate** for allocation of the contract price to each component, again maximizing the use of observable information. If it is not practicable for governments to make a best estimate for price allocation for some or all contract components, *e.g.*, due to the unique nature of leases specifically designed for the leasing parties, specific provisions stipulated in certain lease contracts or other circumstances, a government should account for multiple-component contracts as a single lease unit based on the primary lease component.

An explicit exception to the lease allocation guidance is not provided for contracts with insignificant nonlease components, though general materiality considerations apply. However, if components are material, governments are required to separate them. Setting a policy not to separate components is not allowed under Statement 87.

The Leases Exposure Draft would have required governments to obtain observable standalone prices to provide positive evidence corroborating the reasonableness of individual contract prices. Statement 87 instead provides for a determination that individual contract prices do not appear unreasonable, thus avoiding the implication that governments are required to obtain independent, standalone price verification.

This means that governments are provided with the flexibility to use other reasonable and more cost-beneficial methods to allocate consideration, while being cautioned that the use of readily available observable standalone prices should be maximized.

Practice Point:

- *Multiple-component equipment and real estate contracts with differing lease terms are common—and a lessor government is not required to identify prices for each contract component and disclose those prices to the lessee government. To streamline their lease reporting, lessee governments may consider establishing a policy to obtain and agree upon component information as part of their lease procurement process, particularly for lease components in different major asset classes and leases with nonlease (service) components. Information by asset class is required for disclosure purposes.*

The reporting for lease contracts with multiple underlying assets and lease contracts with a nonlease service component should be the same—as if the components were in separate contracts.

Multiple Concurrent Contracts

Contracts entered into at or near the same time with the same counterparty are subject to combination for financial reporting purposes only if the contracts are negotiated as a package with a single objective, or the consideration to be paid in one contract depends on the other contract's price or performance.

Practice Point:

- *Contracts simultaneously executed and meeting either criterion generally indicate that the substance of the contracts is a single lease. Nonetheless, lessors and lessees will still be required to evaluate the newly combined contract in accordance with the guidance for multiple lease components.*

Lessee Accounting

Initial Measurement of the Lease Liability

For all leases, except for short-term leases and contracts that transfer ownership of the underlying asset to the lessee and do not contain termination options, the lessee will record a lease liability.

The lease liability should be measured at the present value of future lease payments expected to be made during the lease term. Lease payments include fixed payments and variable lease payments that depend on an index or rate, *e.g.*, the Consumer Price Index or a market index rate. Fixed payments are payments established at specific amounts in the lease contract for which the lessee is obligated to make. Variable payments dependent on an index or rate have a baseline measurement at the lease term's commencement. This rate is used to initially measure the lease liability and is assumed to stay in effect throughout the lease term.

Variable payments that depend on the lessee's future performance or usage of the underlying asset do not have a baseline measurement at lease term commencement and are excluded from the initial liability, *e.g.*, copier lease payments contingent on copier usage or rental car payments dependent on miles incurred. However, any minimum guarantee amounts or other portions of variable payments that are fixed in substance, *i.e.*, they can be readily measured, should be included in the lease liability.

Other types of payments, such as those arising from the lessee's exercise of a purchase option or residual value guarantees (RVG), may be contingent on future events. Such payments should be included in the measurement of the lease liability if it is reasonably certain that the option will be exercised or the RVG payment will be required.

The same "reasonably certain" threshold applies to contingent payments for determination of the lease liability as is used when assessing the lease term. For example, lease termination penalties are included in the initial measurement of a lease liability if the lease term reflects that it is reasonably certain a lessee will exercise a lease termination option or fiscal funding or cancellation clause.

Lease incentives to be provided after lease inception reduce the amount of the initial lease liability recorded (and any remeasurement) if they are fixed or fixed in substance. The lease incentives to be received should be accounted for as a reduction of the lease payment to be made, in the year it is to be provided, measured by lessees consistent with the lessee's lease liability. Variable or contingent lease incentives are not included in the initial measurement.

Lease incentives receivable from the lessor reduce the lessee's lease liability because they are components of the same transaction with the same counterparty and, thus, the payable and receivable can be offset.

Discount Rate

Lessees are required to discount lease payments using the interest rate at which the transaction is made, *i.e.*, the rate the lessor charges the lessee, which may be the rate implicit in the lease. Consistent with current guidance, if the interest rate implicit in the lease is not readily determinable, the lessee's estimated incremental borrowing rate should be used. Determining the incremental borrowing rate entails estimating the interest rate the lessee would be charged for borrowing the lease payment amounts during the lease term.

Practice Point:

- *Capital and operating leases often are treated differently for calculating debt covenants or statutory debt limits, and the recording of all in-scope leases as financing transactions may cause some governments to be noncompliant. Governmental entities with proprietary or business-type activities also may experience changes to leverage and performance ratios caused by recognizing leases as financing transactions. Governments are encouraged to proactively work with grant providers and other financial statement users, e.g., lenders, municipal bond investors and analysts, to address changes in lease reporting and potential changes in statutes and policies, debt limits and compliance with debt covenants.*

Initial Measurement of Lease Asset

Initial measurement of the intangible right-of-use asset is based on the lease liability's initial measurement, adjusted for certain prepayments, incentives and direct costs. A lessee should add lease payments made at or before lease commencement to the leased asset's initial measurement. Conversely, a lessee should reduce the amount capitalized by the amount of lease incentive payments received from the lessor at or before lease inception. Initial direct costs incurred to place a lease asset into service should be accounted for as if they were paid in a financed purchase of a capital asset. That means ancillary charges such as legal and administrative structuring fees should be added to the lease asset measurement. Initial direct costs that would be considered debt issuance costs under paragraph 12 of Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, should be recognized as outflows of resources, *e.g.*, expense/expenditure, in the period incurred.

Subsequent Years' Recognition & Measurement

Consistent with the foundational principle that a lease is a financing, a lessee is required to recognize interest expense related to discount amortization on the lease liability, with payments first allocated to the accrued interest liability and then to the lease liability.

A lessee also should recognize amortization expense related to the lease asset, representing the decrease in useful life of the right to use the underlying asset. Amortization of the lease asset should be calculated in a systematic, rational manner over the shorter of the lease term or the underlying asset's useful life, consistent with depreciation and amortization of other capital assets. While many governments will choose a straight-line method, other patterns of amortization could be acceptable.

For leases with bargain purchase options reasonably certain of being exercised, the lessee should amortize the lease asset over the underlying asset's useful life. However, if the underlying asset is nondepreciable, *e.g.*, land, the lease asset should not be amortized.

For reporting purposes, interest and amortization expense may be combined with other interest and depreciation or amortization expense amounts on capital assets, respectively.

Lease expenses for today's operating leases will no longer be classified as a single rent expense, but will instead be recorded as separate interest and amortization components. Guidance on reporting of cash flows is provided in Implementation Guide No. 2016-1, Implementation Guidance Update—2016, Question 5.2.

Remeasurement

The lease liability should be remeasured at subsequent reporting dates if one or more of the following occurs, presuming the changes individually or in the aggregate are expected to significantly affect the lease liability since the last measurement:

- The lease term changes*
- Based on an assessment of all relevant factors, the likelihood of an RVG being paid or purchase option being executed changes from "reasonably certain" to "not reasonably certain" or vice versa*
- The estimated remaining payments change from the amount included in the lease liability measurement
- The rate the lessor charges the lessee changes, if used as the initial discount rate

* Changes to the lease term or the likelihood of a purchase option being executed requires a lessee to update the discount rate when the changes—individually or in the aggregate—are expected to significantly affect the recorded lease liability. The discount rate should be based on the revised rate the lessor charges the lessee or, if not readily determinable, the lessee's estimated incremental borrowing rate at the time of update.

Remeasurement also should occur when a contingency—upon which some or all of the variable payments expected to be made over the lease term's remainder are based—is resolved such that those payments meet the criteria for inclusion in the lease liability. For example, an event occurs causing variable payments contingent on the underlying asset's performance or use has occurred, causing the payments to become fixed or fixed in substance.

If remeasurement is triggered, the liability also should be adjusted for changes to the index or rate used to determine variable payments, if the change is expected to significantly affect the previous measurement's liability amount. Changes in an index or rate used to measure variable payments do not, in and of themselves, require liability reassessment. Likewise, the lessee is not required to remeasure the lease liability or reassess the discount rate solely because of changes in its incremental borrowing rate.

Lessees should adjust the lease asset by the same amount as the corresponding lease liability, except if the lease asset's carrying value is reduced to zero. If this occurs, any remaining amount should be reported in the resource flows statement as a gain.

Impairment

In accordance with Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, a capital asset is considered impaired when its service utility has significantly and unexpectedly declined. Accordingly, lease asset impairment generally links to impairment of the lessee's right to use the underlying asset caused by its impaired service utility. A significant decline in the underlying lease asset's service utility may be determined by assessing changes in the length of time during which the underlying asset can be used (duration of use) or in the way the underlying asset can be used (manner of use), compared to its previously expected duration and manner of use.

If a lease asset is impaired, it should be reduced first for any change in the corresponding lease liability, and any remaining amount should be recognized as an impairment.

Lessee Disclosures

Disclosure requirements have been enhanced under Statement 87 to provide information about the full cost of leases. Lessees are required to disclose the expense (or expenditure) recognized in the period for variable lease payments, RVGs or termination penalties not previously included in the lease liability's measurement.

Other leasing activity disclosures include a general description of the leasing arrangement, the total amount of lease assets and related accumulated amortization, lease assets by major class of underlying assets, impairment loss components and principal and interest requirements to maturity, presented separately for each of the five subsequent years and in five-year increments thereafter included in the lease liability. Disclosures also are required for lease commitments on upcoming leases, sublease, sale-leaseback and lease-leaseback transactions.

A lessee's general description of its leasing arrangements should include the basis for determining variable payments not be included in the lease liability, and the terms and conditions of RVGs provided by the lessee not included in the lease liability.

Practice Note:

- *Preparers may aggregate disclosures when appropriate and consider a lease transaction's significance in compiling the information necessary to meet the disclosure requirements. This may alleviate some governments' concern over disclosing too much information and losing their lease negotiating ability*.

GASB agreed to not provide guidance regarding where to place and how to structure lease disclosures in the notes to the financial statements, including commitments under leases that have not yet begun. Preparers should continue to use professional judgment to determine how to present the disclosure requirements in a manner that is useful and understandable to users.

Lessor Accounting

Scope Exceptions

In addition to the exception for short-term leases and leases that transfer ownership, Statement 87 provides an exemption to the lessor **recognition and measurement** requirements for leases of investment assets and certain regulated leases, but specific disclosure requirements are required for them. Nonaviation leases at airports, such as concession leases, and leases that form the revenue stream that supports repayment of certificates of participation are within Statement 87's scope.

Leases of Investment Assets

Statement 72 defines an investment and provides accounting guidance for assets meeting that definition. For leases of investment assets, a lessor would be prohibited from applying lessor guidance on recognizing and measuring a lease receivable under Statement 87 even though the arrangement would otherwise be accounted for as a lease. This is because the fair value of leased investment property, *e.g.*, real estate, often is determined through a present value calculation that essentially would be the same as the lease receivable.

The suite of general lessor disclosure requirements, discussed below, will not apply to leases of investment assets. The lessor only is required to disclose the terms and conditions of lessee termination options or payment abatements if the lessor government has issued debt related to the investment asset for which the principal and interest payments are secured by the lease.

For example, a lessor subleasing an underlying asset solely for profit would apply the recognition, measurement and disclosure guidance under Statement 72 and the disclosure requirements for investment assets under Statement 87.

Certain Regulated Leases

Aviation leases between airports and air carriers (often referred to as airport–airline agreements) and other leases with similar characteristics are excluded from Statement 87's recognition and measurement requirements, primarily because they have characteristics different from normal financing arrangements. In addition, there often are measurement difficulties. Airport-airline lease agreements generally require payments that vary from period to period because of their cost-recovery nature, and many also contain revenue-sharing provisions.

To qualify for the exception, the lease must be subject to external laws, regulations or legal rulings that establish the following requirements:

- The lease rates cannot exceed a reasonable amount, with reasonableness being subject to determination by an external regulator
- Lease rates are similar for lessees that are similarly situated
- The lessor cannot deny potential lessees the right to enter into leases if facilities are available, provided that the lessee's use of the facilities complies with generally applicable use restrictions

Lessors meeting all the requirements should recognize inflows of resources, *e.g.*, revenue, based on the lease contract's payment provisions.

The "regulated leases" exception does not apply to leases that do not meet specific criteria, e.g., most leases of terminal space to restaurants and other nonaviation-related vendors at airports. These leases are not considered substantively different from other nonregulated leases, e.g., leases of vendor stalls at government-owned sports stadiums.

Practice Point:

- *The exception criteria apply to all regulated aviation leases at airports, including lease agreements in which the airports and air carriers voluntarily agree to rates in excess of costs (as long as those rates are consistently applied between similarly situated air carriers), or instances in which legal requirements allow lease rates to recover more than cost, such as for debt service coverage.*

Disclosures for regulated leases meeting Statement 87's criteria are based on the general lessor disclosure requirements (discussed below), modified to address the leases' uniqueness. Lessors with one or more regulated leases, other than short-term leases, are required to disclose the extent to which capital assets are subject to preferential or exclusive use by counterparties under agreements, by major asset class and by major counterparty. For example, an airport could disclose the total number of terminal gates and the number of gates being leased by each major tenant under preferential or exclusive agreements. This concentration of credit risk disclosure replaces the proposed disclosure of the carrying amount of assets on lease or held for leasing included in the Leases Exposure Draft.

Also required is a lessor's disclosure of the existence, terms and conditions of lessee options to terminate the lease or abate lease payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments.

Disclosures may be grouped.

Initial Measurement of Lease Receivable & Deferred Inflow of Resources

Statement 87 requires a lessor to record a lease receivable measured at the present value of future lease payments expected to be received during the lease term, reduced by any provision for uncollectible amounts. Measurement of the receivable includes fixed payments, variable payments that depend on an index or rate (initially measured using the index or rate as of lease term commencement), variable payments that are fixed in substance, RVGs that are fixed in substance and any lease incentive payments to be provided after lease term commencement. Lessors should account for lease incentive as reductions of lease payments for the periods in which the incentive payments will be provided, consistently measured with the lessor's lease receivable (and included in any remeasurement).

Variable payments based on future performance of the lessee or usage of the underlying asset should not be included in the lease receivable's measurement. Rather, those variable payments should be recognized as inflows of resources, *e.g.*, revenue, in the period to which those payments relate. Examples include variable payments based on a percentage of airport terminal restaurant sales or vendor stall sales at government-owned sports stadiums.

Certain components of the lease receivable—fixed payments, variable payments that depend on an index or rate or are fixed in substance—are symmetrical with components of the lessee's lease liability. However, an RVG or lease purchase option that is not fixed in substance may be recognized later in a lessor receivable than in a lessee's liability, even if it is reasonably certain that the payments will be made.

Other types of payments, such as those arising from purchase options and RVGs that are not fixed in substance, but contingent on future events, are not included in the lessor's initial measurement. Instead, a lessor should record a lease receivable and recognize inflows of resources, *e.g.*, revenue, at the time a not-fixed-in-substance RVG's guarantee payment is required—as agreed to by the lessee and lessor—and the amount can be reasonably estimated. Likewise, amounts to be received for the exercise price of a purchase option or penalty for lease termination should be recognized as a receivable and an inflow of resources, *e.g.*, revenue, when those options are exercised.

Lessors have information to determine the interest rate it charges the lessee, including implicit rates, and should use this rate to discount the future lease payments.

Lessors should recognize a deferred inflow of resources corresponding to the lease receivable's initial measurement, plus lease payments received from the lessee at or before lease commencement that relate to future periods, *e.g.*, the final month's rent, less any lease incentives paid to, or on behalf of, the lessee at or before lease commencement.

The underlying asset is not derecognized.

Statement 87 is based on the premise that a lessor's relinquishing the right to use an asset, which it still owns, does not diminish the asset's historical cost recognized. Hence, unlike the current treatment for capital leases under Statement No. 62, lessors will not derecognize the underlying asset under Statement 87.

Practice Point:

- *Lease payments may be established using a method that does not involve an interest rate, e.g., by comparison of market rents for similar pieces of real estate. In this example, even if the rate is not factored into determining the payment amounts, a lessor could impute a discount rate on the future payment stream. Statement 87 does not require imputation of interest, but lessors may do so, as in this example, to determine the rate implicit in the lease.*

Statement 87 supersedes Statement 62's guidance on accounting for leveraged leases—leases that involve a creditor providing long-term financing to the lessor for the underlying asset's acquisition—and situations when the underlying lease asset is sold or the lease is assigned to a third party. For leveraged leases, no replacement guidance is given in Statement 87 primarily because they are uncommon in the government. For underlying asset sale or assignment, a lessor's determination of whether a sale has occurred should be made regardless of whether a lease is in place.

Subsequent Years' Recognition & Measurement

Revenue is recognized over the lease term, with interest revenue and other lease-related revenue separately reported in the resource flows statement. In alignment with lessee accounting, payments received should be allocated first to the accrued interest receivable—current year's amortization of the lease receivable's discount using the effective interest method—and then to the lease receivable. Also in alignment with lessee accounting, a lessor should recognize inflows of resources, *e.g.*, revenue, in a systematic and rational manner over the lease term.

The underlying asset in a lease should continue to be accounted for in accordance with other applicable guidance, including depreciation and impairment, except if the lease contract requires the lessee to return the asset in its original or enhanced condition. In this circumstance, the lessor would not depreciate the asset during the lease term because the service capacity of that asset would be assessed at an amount at least the same at the end of the lease as it was at the beginning. Accordingly, it would not be appropriate to recognize a reduction through depreciation.

Remeasurement

Remeasurement should occur at subsequent financial reporting dates when there is a change in the lease term or the interest rate the lessor charges the lessee, or when a contingency existing at lease commencement is resolved and variable payments meet the criteria for measuring the lease receivable, *e.g.*, an event occurs whereas variable payments contingent on the performance or use of the underlying asset become fixed payments for the lease term's remainder, provided the changes—individually or in the aggregate—are expected to significantly affect the lease receivable amount since the previous measurement. In all other situations, variable lease payments should only be remeasured if the liability is already required to be remeasured.

Practice Point:

- *Remeasurement is common in a concessionaire's lease requiring a nominal payment in the first year and fixed payments in subsequent years based on a percentage of first-year sales.*

Certain payments are included in the lessee's liability before they are recognized in the lessor's receivable. For example, a lessee recognizes a liability for a purchase option that is reasonably certain of being exercised, but a lessor does not recognize a receivable until the option is exercised. Because of this, a lessor would not remeasure the receivable even if the lessee's liability is remeasured for changes in probability.

If the lease receivable is being remeasured, it should be adjusted for a change in the index or rate used to determine variable payments if the change is expected to significantly affect the receivable amount since the previous measurement. A lease receivable is not required to be remeasured solely for a change in an index or rate used to determine variable payments.

The basis for requiring a lessor's reassessment of the discount rate is the same as for reassessment by a lessee. That means the discount rate should be updated (and receivable remeasured) if there is a change in the lease term or interest rate the lessor charges the lessee, provided the changes individually or in the aggregate are expected to significantly affect the lease receivable amount. At that time, the receivable should be remeasured using the revised rate.

The deferred inflow of resources balance generally should be adjusted by the same amount as any changes resulting from remeasurement of the lease receivable.

Lessor Disclosures

General Lessor Disclosure Requirements

Like lessees, lessors are required to disclose more information about the effect on current resources arising from leasing activities than Statement 62 requires. Lessors are required to disclose the total amount of resource inflows from leasing activities, *e.g.*, lease revenue and interest revenue, if the amounts cannot be determined based on the amounts displayed on the face of the financial statements, and resource inflows from variable lease payments and other payments not previously included in the lease receivable, *e.g.*, payments received from RVGs and termination penalties.

Statement 87 carries forward the Statement 62 requirements to disclose a general description of the leasing arrangement, including a description of the basis on which any variable payments not included in the lease receivable are determined.

Statement 87 also expands on the current requirement to disclose the future minimum lease payments to be received for each of the five succeeding years to also include a schedule of future minimum lease payments in five-year increments thereafter, with principal and interest separately presented. However, only lessors whose principal ongoing operations consist of leasing assets to other entities and lessors with certain regulated leases are required to prepare this disclosure.

The existence, terms and conditions of options by the lessee to terminate the lease or abate payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments are required for all leases, including leases of investment assets and certain regulated leases.

Lessors also should apply the relevant disclosures for certain regulated leases, investment leases subject to Statement 72, sublease and sale-leaseback and lease-leaseback transactions.

Proposed requirements in the Leases Exposure Draft for lessors to disclose the carrying amount of assets on lease or held for leasing and the related accumulated depreciation have not been carried forward to the final statement. In addition, disclosing a schedule of future lease payments included in the lease receivable is only required for governments whose principal ongoing operations consist of leasing activities.

Lease Incentives

A lease incentive is a payment made to, or on behalf of, the lessee, for which the lessee has a right of offset with its obligation to the lessor—equivalent to a rebate or discount—or is in the form of other lessee concessions. As used in this statement, these include assumption of a lessee's pre-existing, third-party lease obligations, other reimbursements of lessee costs, rent holidays and reductions of interest or principal charges by the lessor. A lessor-provided leasehold improvement is another example of a lease incentive payment if, for example, it provides additional assets to the lessee without additional cost.

Statement 87 includes explicit guidance to clarify the accounting for lease incentives based on whether they are received at or before lease inception, or after lease inception. Lease incentives that provide payments to, or on behalf of, a lessee on or before lease commencement directly reduces the lessee's recorded initial lease asset amount. Payments to be provided after lease commencement should be accounted for by both the lessee and lessor as reductions of lease payments in the year the payments will be provided, consistent with leases liability and receivable measurement principles, respectively. Accordingly, only lease incentive payments that are fixed or fixed in substance are included in the initial measurement and subject to remeasurement.

Lease Modifications & Terminations

Overview

Accounting for a lease should reflect changes to the lease contract's provisions. As discussed above, certain changes under the lease contract or estimates **incorporated into** the contract's measurement require remeasurement of a lessee's liability or a lessor's lease receivable, if the change is expected to significantly affect the amount recorded. Lease modifications and terminations, however, are not changes **under** the original lease contract. Instead, they are **amendments to** the original lease contract while the contract is in effect—which may require recording a new and separate lease.

In a lease modification, the lessee retains the same right to use the underlying asset, even if the lessee will be paying less for that right going forward. Example lease modifications include an agreement by both parties to extend a lease when there is no option to extend, revise payment amounts or add an underlying asset. If the lessee's right to use the underlying asset decreases, the amendment is instead considered a partial or full lease termination.

Lease Modification Accounting

The provisions for lease modification accounting are similar to prior guidance in Statement 62. If the lease modification gives the lessee an additional lease asset by adding one or more underlying assets that were not included in the original lease, the additional portion of a modified lease should be accounted for as a new lease. However, if lease payments for the additional lease asset appear to be unreasonable based on the amended contract's terms and the use of professional judgment, the modification should be accounted for as an amendment of the existing lease.

All other lease modifications, such as lengthening the lease term, result in lease term reassessment rather than reporting as a separate lease. Lessees will remeasure the lease liability (and corresponding asset), and lessors will remeasure the lease receivable (and corresponding deferred inflow of resources), in accordance with Statement 87's remeasurement guidance.

Modifications Resulting from a Lessor's Debt Refunding

The guidance for lease modifications resulting from a lessor's debt refunding (including an advanced refunding) in which the refunding's perceived economic advantages are passed through to the lessee has been modified from Statement 62 to align the provisions with the basic principles established in this Statement 87. In other words, the accounting differences between capital and operating leases have been removed.

A lessor should account for the changed lease provisions resulting from a debt refunding by adjusting the lease receivable to the present value of the future minimum lease payments using the interest rate in the revised lease contract, with a corresponding adjustment to deferred inflows of resources.

Lessees should likewise adjust their lease liability to the present value of the future lease payments under the revised lease using the effective interest rate applicable to the revised lease contract. The difference should be reported as a deferred outflow of resources (deferred loss) or a deferred inflow of resources (deferred gain) to be amortized as a component of interest expense/expenditure in a systematic, rational manner over the remaining life of the old or new debt, whichever is shorter. If the advanced refunding results in a defeasance of debt, the lessee should recognize costs it is obligated to reimburse to the lessor, *e.g.*, unamortized discount or a call premium, also in a systematic, rational manner over the remaining life of the old or new debt, whichever is shorter.

Partial & Full Lease Termination Accounting

An amendment that diminishes—but does not terminate—the lessee's right to use the underlying asset should be accounted for as a partial lease termination, not as a modification. This includes shortening the lease term or reducing a lease from, for example, four vehicles to three. Alternatively, the lessee and lessor might agree to a full termination prior to a lease's scheduled end date, even if such a provision was not included in the most recent lease contract.

If a lease is fully or partially terminated, the lessee no longer has the same right to use the underlying asset and is required to remove the carrying value—or a portion thereof—of the intangible lease asset representing the lost right to use. The corresponding lease liability also is reduced with gain or loss recognition for the difference. A lessee's purchase of the underlying asset is recorded at the right-to-use asset's carrying value and reclassified to the appropriate asset class.

Accordingly, a lessor should reduce the carrying value of the lease receivable and deferred inflow of resources for the partial or full termination and recognize a gain or loss for the difference. Derecognition of the underlying asset due to a purchase of the asset by the lessee should be considered in the lessor's gain or loss calculation.

Sale-Leaseback Transactions

A sale-leaseback transaction is a transaction that qualifies as a sale under the guidance for sales of real estate in Statement 62. Any difference between the carrying value of the capital asset that was sold and the net proceeds from the sale should be reported as a deferred inflow or deferred outflow of resources by the seller-lessee over the leaseback's term, regardless of how much of the asset's use the seller-lessee retains. The deferral should be recognized in the resource flows statements in a systematic, rational manner over the lease term. If the transaction's lease portion qualifies as a short-term lease, the gain or loss should be immediately recognized. If the transaction does not include a qualifying sale, it should be accounted for as a financing because the substance of the transaction is a borrowing/lending activity (rather than an asset sale).

Practice Point:

- *The sales-of-real-estate criteria include the provision that an option or requirement for a seller to repurchase the asset would preclude sale treatment. Such a transaction generally would be subject to existing standards for long-term liabilities, including disclosures.*

A seller-lessee is required to disclose the terms and conditions of a sale-leaseback transaction, including, for example, any commitments made or further involvement of the seller-lessee in carrying out the transaction, in addition to the general lessee disclosure requirements. A buyer-lessor would provide the general lessor disclosure requirements. Sale-leaseback transactions with off-market terms should be reported based on the transaction's substance rather than as part of the sale-leaseback transaction, *e.g.*, as a borrowing, a nonexchange transaction or an advance lease payment.

Entities applying the regulated operations guidance in Statement 62—and meeting Statement 62's related criteria—are required to follow separate sale-leaseback recognition guidance. The difference between the amount of resource inflows or outflows, *e.g.*, revenue or expense, in the sale-leaseback transaction and the amount of inflows or outflows included in allowable cost for rate-making purposes should be recognized as a separate regulatory-created asset or deferred inflow of resources.

Lease-Leaseback Transactions

In a lease-leaseback transaction, each party is both a lessor and a lessee. Because each portion of the transaction is with the same counterparty, a right of offset exists and the transaction should be recorded net—even if the leaseback involves an additional asset or only a portion of the original asset. Both parties are required to disclose the gross amounts of the lease and leaseback to provide users with information about the magnitude of each portion of the transaction.

Subleases

A sublease is accounted for as a transaction separate from the original lease, except for a lease-leaseback transaction such that the right of offset exists. That means a lessee's transactions as the sublease lessor in a sublease are required to be reported separately from the lessee transactions.

The lessee as the sublease lessor also should include the sublease separately in its lessor and lessee disclosures. The existing requirement for separate disclosure of sublease payments to be received is not required under Statement 87 (payments to be received from subleases will be included in the lease receivable and the sublease lessor's note disclosure of future lease payments).

Practice Point:

- *A transaction that relieves the original lessee of its obligation under the lease is a lease termination rather than a sublease.*

Intra-Entity & Related-Party Leases

The provisions for reporting leases within the same financial reporting entity have been carried forward with clarifying edits. That means when the lessee or lessor is included as a blending component unit, the lessor's debt and assets should be reported as if they were the primary government's debt and assets. Henceforth, capital assets leased from a blended component unit should be reported as capital assets, and related debt would be reported as a long-term liability in the reporting entity's governmentwide financial statements.

Each entity would continue to apply Statement 87 in any separate financial statements, but eliminations for leases with or between blended component units should be made before the separate financial statements are aggregated with the primary government. Any remaining cash payments between component units are reported as inflows, outflows or resources.

Leases between the primary government and discretely presented component units—or between discretely presented component units—are subject to Statement 87's general provisions. Related receivables and payables should not be combined with other amounts due to or from the discretely presented component unit or with lease receivables and payables with organizations outside the reporting entity.

Leases between related parties are subject to requirements in Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, requiring the parties to report the substance of the transaction, if significantly different from its form. In addition, the nature and extent of related-party leasing transactions should be disclosed. Governmental entities with an interest in an investee accounted for using the equity method should account for the related-party lease in accordance with applicable guidance in Statement 62 and Statement 72.

In all other aspects, the classification and accounting should be the same as for similar leases between unrelated parties.

Practice Point:

- *Although the emphasis in Statement 87 is on legally enforceable rights and obligations stemming from a lease contract, financial statement preparers should recognize the substance of a lease arrangement with a related party, if significantly different than its form. Leases structured in a manner that distorts the substance of the transaction should be avoided, particularly structures to obtain short-term classification.*

Statement 87 does not change the guidance for intra-entity leases established in National Council on Governmental Accounting Statement 5, as referenced in GASB Statement No. 14, The Financial Reporting Entity. GASB decided to provide specific guidance in Statement 87—considered application of general guidance for transactions within a financial reporting entity—for elimination of leases with or between blended component units to promote consistency in reporting among governments.

Transition

Statement 87's provisions should be retroactively applied by restating the financial statements, if practicable, for all prior periods presented. Reasonable efforts should be employed before a government determines that restatement of all prior periods presented is not practicable, and "inconvenient" should not be considered a baseline for not restating. If restatement is not practical, the cumulative effect of applying Statement 87, if any, should be reported as a restatement of beginning net position—or fund balance or fund net position—for the earliest period presented.

Leases should be recognized and measured using the facts and circumstances that existed at the beginning of the implementation period, or the beginning of the earliest period restated. Lessor governments that previously derecognized underlying assets in accordance with Statement 62's guidance for sales-type or direct-financing leases are not required to determine the underlying asset's value at the time of implementation and recognize it. Instead, any residual asset included in the net investment in the lease recorded under Statement 62 should become the new carrying value of the underlying asset.

In the first restatement period, the notes to the financial statements should disclose the restatement's nature and effect and the reason for not restating prior periods, as applicable.

GASB will consider developing illustrations and examples as part of potential implementation guidance. For further guidance, contact your BKD advisor.

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Elements Included in Lease Measurement: Comparison of Lessee & Lessor Requirements

Lease Element	Included by Lessee	Included by Lessor
Future lease payments (fixed payments, payments fixed in substance and variable payments dependent on an index or rate)	Yes	Yes, reduced by any provision for uncollectible amounts
Variable payments dependent on a lessee's future performance or usage of the underlying asset	No	No
A purchase option contingent on future events, *e.g.*, the lessee's exercise of the option	Yes, if the lessee is reasonably certain that it will exercise the option*	No, the purchase option amount is recognized as a receivable when the option is exercised
An RVG contingent on future events (is not fixed or fixed in substance)	Yes, if the lessee is reasonably certain that it will be required to pay the RVG*	No, the RVG is recognized as a receivable when the payment is required and can be reasonably estimated
An RVG payment fixed in substance	Yes	Yes
Lease incentives, fixed or fixed in substance, to be provided after lease inception	Yes, as a reduction to the lease liability	Yes, as a reduction to the lease receivable
Lease incentive payments received by the lessor at or before lease inception	Yes, as a reduction to the right-of-use lease asset	Yes, as a reduction to deferred inflow of resources
Lease payments made at or before lease commencement	Yes, as an addition to the right-of-use asset	Yes, as an addition to deferred inflow of resources
Initial direct costs to place the underlying asset in service, *e.g.*, ancillary charges such as legal and administrative structuring fees	Yes, as an addition to the right-of-use asset	Not applicable
Lease termination penalties	Yes, if the lessee is reasonably certain that it will exercise a lease termination option or fiscal funding or cancellation clause*	No, the termination penalty amount is recognized as a receivable when the option is exercised

** A lessee will remeasure recorded amounts when, based on an assessment of all relevant factors, it determines that the likelihood that an RVG being paid or purchase option being executed changes from "reasonably certain" to "not reasonably certain," or vice versa, or if the lessee determines that the likelihood that a termination option being executed changes from "reasonably certain" to "not reasonably certain" or vice versa, which causes a change in the lease term or estimated remaining payments from the amount included in the lease liability measurement.*

Elements Included in Lease Term Assessment

Lease Element	Included in Lease Term Assessment
Noncancelable periods	Yes
Periods subsequent to when the lessee or lessor has the option to extend the lease (lease extension periods) *(a)*	Yes, if it is reasonably certain the option will be exercised
Periods subsequent to when the lessee *or* the lessor has the option to terminate the lease (lease termination periods) *(b)*	Yes, if it is reasonably certain the option will not be exercised
Lessee and lessor notice periods	Yes
Periods in which *both* the lessee and lessor have the option to terminate the lease, including periods in rolling month-to-month or year-to-year leases cancelable by one party to the lease without permission from the other party (or both must agree to extend the lease), or holdover periods of leases that continue until a new lease contract is signed *(c)*	No

(a) Periods are included in the lessee and lessor's assessment of whether the lease qualifies for the short-term scope exception under the "maximum possible term" threshold, regardless of the probability of being exercised.

(b) Periods are excluded in the lessee and lessor's assessment of whether the lease qualifies for the short-term scope exception under the "maximum possible term" threshold, regardless of the probability of being exercised.

(c) Periods are cancelable periods excluded from the short-term lease assessment, regardless of whether it is reasonably certain the option to terminate will not be exercised by both parties, or an agreement to extend the lease will be reached.