State of Arizona General Accounting Office

GASB 87 Overview

Introduction

In June 2017, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 87, Leases. This statement supersedes or amends parts of 15 existing statements. GASB 87 overhauls the accounting and financial reporting of leases for state and local governments by establishing a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying nonfinancial asset.

The objective of this statement is to improve the consistency of accounting and reporting for leases by requiring recognition of certain lease assets and liabilities for leases. GASB 87 will enhance the comparability, relevance, and reliability of information about the leasing activities of governments.

Per GASB Statement No. 95 issued May 2020, GASB 87 is effective for all reporting periods beginning after June 15, 2021. GASB 87 must be implemented for the fiscal year beginning July 1, 2021 and will require a restatement of beginning balances for all periods presented (retroactive application).

Identifying Leases

Under pre-GASB 87 guidance, governments distinguished between operating and capital leases. Beginning in fiscal year 2022 and for all prior periods presented, there is no longer a distinction between operating and capital leases. All leasing arrangements as defined by GASB 87 will now be treated as financings of the right to use the leased asset.

GASB 87 defines a lease as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset, such as land, a building, a vehicle, or equipment) as specified in the contract for a period of time in an exchange or exchange-like transaction. (A transaction is an exchange or exchange-like when each party in the contract receives or gives up essentially equal value.)

- The contract must be legally enforceable.
- A contract conveys control of the right to use the underlying asset if it has both of the following:
    - The right to obtain the present service capacity from the use of the underlying asset as specified in the contract; and
    - The right to determine the nature and manner of use of the underlying asset specified in the contract.

Contracts for services are excluded, and contracts that contain both a lease component (such as the right to use a building) and a service component (such as maintenance services for the building) should separate and report only the lease component, if practicable.

GASB 87 Applicable Lease Types

Payable Leases (State as lessee)

Payable leases require the State, as lessee, to recognize a lease liability and an intangible right-to-use lease asset.

The State measures lease liability as the present value of payments expected to be made during the lease term (less any lease incentives) and is centrally calculated.

Lease liabilities are correctly calculated when agencies provide the following information:

- Fixed payments;
- Variable payments that depend on an index or a rate (Consumer Price Index or market interest rate), initially measured using the index or rate as of the beginning of the lease term;
- Variable payments fixed in substance;
- Amounts reasonably certain of being required to be paid by the lessee under residual value guarantees;
- The exercise price of a purchase option if it's reasonably certain that the lessee will exercise that option;
- Payments for penalties for lease termination if it's reasonably certain that the lessee will exercise that option, including:
    - lease terms with an option for the lessee to terminate the lease;
    - fiscal funding clause; or
    - cancellation clause.
- Lease incentives* receivable from the lessor; (*Lease incentives are (a) payments made to, or on behalf of, the lessee, for which the lessee has a right of offset with its obligation to the lessor, or (b) other concessions granted to the lessee.)
- Other payments that are reasonably certain of being required based on an assessment of all relevant factors.

Lease assets are correctly calculated when agencies provide the following information:

- Amount of the initial measurement of the lease liability.
- Lease payments made to the lessor at or before the beginning of the lease term, less any lease incentives received from the lessor at or before the beginning of the lease term
- Initial direct costs that are ancillary charges required to place the lease asset into service. (Examples may include delivery and installation costs.)

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Revenue Leases (State as lessor)

Revenue leases require the State, as lessor, to recognize a lease receivable and a deferred inflow of resources.

Lease receivables are correctly calculated when agencies provide the following information:

- Fixed payments;
- Variable payments that depend on an index or a rate (Consumer Price Index or market interest rate), initially measured using the index or rate at the beginning of the lease term;
- Variable payments fixed in substance;
- Residual value guarantee payments fixed in substance; and
- Lease incentives.

Deferred inflow of resources are correctly calculated when agencies provide the following information:

- Amount of the initial measurement of the lease receivable.
- Lease payments received from the lessee at/or before the beginning of the lease term that relate to future periods, less any lease incentives paid to, or on behalf of, the lessee at/or before the beginning of the lease term.

Subleases

A sublease is a property rental agreement by a tenant to a third-party for a portion of the tenant's existing lease contract.
Example: A state agency leases a floor in a building from a vendor and rents a room to another entity. The state agency is then both a lessee and a lessor and must report both.

Sale-leasebacks

A sale-leaseback is the sale of a property with an agreement that it will then be leased back. Only a sale transaction qualifies for sale-leaseback accounting.
Example: A state agency sells a piece of property to a non-state company. The sale includes a contractual agreement that the agency will lease the property back from the company. The agency must report the lease.

Lease-leasebacks

A lease-leaseback is the lease of the property to a tenant with the agreement that the property will then be leased back from that same party (usually with an asset or service attached).
Example: A state agency owns a piece of land and leases it to a non-state company. The agreement obligates the company to build an office and lease it back to the state agency. The agency must report both leases.

Software as Leases Subject to GASB 87 and Reporting Subscriptions

GASB 87, paragraph 8, excludes software. However, contracts may contain an embedded lease of physical computer equipment, which is subject to GASB 87.

Example: A state agency has a contract with a vendor for cloud computing services, which includes the lease of physical servers. GASB 87 applies to the servers, and they must be reported.

Leases exclude

GASB 87 applies to leases of all assets, including subleases, <u>except</u> for the following leases:

- Leases of intangible assets, including:
  - Leases to explore for or use non-regenerative resources
  - Licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, copyrights, and computer software
- Leases of biological assets, including timber, living plants, and animals
- Leases of inventory
- Contracts that meet the definition of a service concession arrangement
- Leases with the underlying asset financed with outstanding conduit debt, unless both the underlying asset and the conduit debt are reported by the lessor
- Supply contracts, such as power purchase agreements
- Short-term leases (see definition below)
- Contracts that transfer ownership (see definition below)
- Inter-agency leases, except if the lease is between State agencies and the following agencies identified as Component Units of the State:
  - Arizona Finance Authority
  - Arizona Power Authority
  - Rio Nuevo Multipurpose Facilities District
  - Arizona Commerce Authority
  - Insurance Department (only for funds ID2114 and ID2154)

Three classifications of "leases"

- Short-term leases - **Not** GASB 87 Leases
  - Initial measurement must have a maximum possible term at commencement date of 12 months or less (including option periods regardless of the plan to exercise them)
  - No recognition of lease liability or lease asset required
  - Short term payments are expensed as incurred by lessees and recognized as revenue by lessors

- Contracts that transfer ownership - **Not** GASB 87 Leases
  - Defined as any contract that:
    - Transfers ownership of the underlying asset to the lessee by the end of the contract, and
    - Does not contain termination options
  - These contracts are accounted for as financed purchases of the underlying asset by lessees and sales by lessors

- All other leases
  - Lease liability and lease asset are recognized
  - Focus of GASB 87
  - Includes all the GASB 87 applicable lease types described above

Determining the Lease Term

For arrangements that meet the GASB 87 definition of a lease, entities will be required to determine the lease term applicable to that lease, whether the entity is a lessee or a lessor in the arrangement.

The lease term is the noncancelable period, plus periods covered by the lessee's or lessor's options to:

- Extend the lease, if reasonably certain of being exercised
- Terminate the lease, if reasonably certain of NOT being exercised

The lease term is determined at the commencement date (i.e. the date the underlying asset is available to the lessee).

Periods for which both the lessee and lessor have an option to terminate or both parties have to agree to extend the lease are cancelable periods and are excluded from the lease term. Fiscal funding/cancelation clauses are ignored unless reasonably certain of being exercised.

A lessee or a lessor is 'reasonably certain' if they have evaluated relevant factors such as economic incentives or disincentives (cost to terminate, market rates for new leases, cancellation penalties, etc.), the history of exercising options to extend or terminate, and how essential the leased asset is to a government's operations. After evaluating these factors, an entity can be reasonably certain if there is a greater than probable chance that one of the above options will or will not be exercised. In certain cases, lease terms should be reassessed. For example, if a lessee exercises an option that it was previously uncertain about, the lease term should be adjusted.

Understanding Lease Terms (in detail)

Lease terms are determined after a full analysis of the contract, including factors surrounding the contract. Don't assume that the contract lease term is the same as the standard lease term.

The lease term includes:

- The noncancelable period;
- Periods covered by lessee's or lessor's option to extend the lease term that you do expect them to exercise; and
- Periods covered by lessee's or lessor's option to terminate that you don't expect them to exercise

Note: If you're reasonably certain the lessee or lessor will exercise a fiscal funding clause, use the date you expect them to exercise the option to determine the end-of-lease term.

Noncancelable Lease Period

- The noncancelable period is when neither the lessee nor the lessor can terminate the contract.
  Example: A state agency contract with a vendor has a termination clause allowing the tenant the right to cancel after 90 days. The noncancelable period is 90 days.

Lease Extension

- Leases may contain an option to extend the lease for a set amount of time.
  Example: A state agency enters a five-year contract with a vendor for office space. This lease has two four-year renewal options. If the agency decides it's reasonably certain it will exercise the first extension, but not reasonably certain it will exercise the second, the lease term is nine years.

Early Termination Period

- Leases may include an early termination option after 30, 60, or 90 days' notice. When this option is available, the termination period occurs after the notice timeframe.
  Example: A state agency enters into a five-year contract with a vendor for office space. After one year, the agency can give 60 days' notice to terminate the lease. The noncancelable period is 14 months. A termination option covers the remaining 46 months. The agency must determine if it is reasonably certain that they won't exercise this option.

Note: The following are not considered termination options: Provisions that allow for termination of a lease due to

- Purchase of the underlying asset
- Payment of all sums due, or
- Default on payments.

Cancelable Periods

Lease term *excludes* cancelable periods when both the lessee and the lessor can terminate without permission from the other party

Examples of Cancelable Periods

- Rolling, month-to-month lease; or
- A lease that continues into a holdover period until a new lease is signed.

Fiscal Funding Clause
Fiscal funding or cancellation clauses allow lessees to cancel a lease if the government doesn't appropriate funds for payments. This typically occurs on an annual basis. A fiscal funding cancellation clause only affects the lease term if it's reasonably certain the clause will be exercised. Review all contracts to see if this clause exists. If it does, you must document your determination of reasonably certain or not reasonably certain.

Making a "Reasonably Certain" Determination
Each state agency must apply its circumstances to GASB-required relevant factors to determine if a lease meets the threshold of "reasonably certain." Relevant factors include:

- **Market-based factors,** such as whether contract terms and conditions for the optional periods are favorable compared with current market rates.
- **Contract-based factors,** such as significant economic deterrents, including costs to terminate an existing lease and sign a new one. Types of costs include negotiation costs, relocation costs, abandonment of significant leasehold improvements, costs of identifying another suitable underlying asset, costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location, or a substantial cancellation penalty.
- **Asset-based factors,** such as whether the asset underlying the lease is necessary for providing government services.
- **Government-specific-based factors,** such as the cost or timeliness of the procurement process or the likelihood to appropriate funds based on historical experience.

Determining the Lease Payments

What is included in Lease payments?

Lease payments include:

Fixed payments	Termination penalties	Purchase options	Variable lease payments (VLPs)	Residual value guarantees (RVGs)	Any other payments
= Fixed payments + in-substance fixed payments – lease incentives	Include unless reasonably certain not to be exercised (lessee only)	Include only if reasonably certain to exercise (lessee only)	Only VLPs that depend on an index or rate are included	Amounts reasonably certain of being paid (Lessees only, different guidance for lessor)	Include only if reasonably certain (lessee only)

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Fixed payments (lessee and lessor)

- **Fixed payments –**Contractually fixed and not subject to any variability.
- **In-substance fixed payments –**May be described as variable but are "in-substance fixed" because contract terms ensure payment of a fixed amount is unavoidable. An example is a lease payment that is at least a certain amount but may increase based on a certain event.
- **Lease incentives –**Defined as (a) payments made to, or on behalf of, the lessee, for which the lessee has a right of offset with its obligation to the lessor, or (b) other concessions granted to the lessee. Lease incentives that are fixed and are to be provided after the commencement date are deducted from the fixed lease payments in the measurement of the lease liability. Lease incentives are equivalent to a rebate or discount and may include:
    - Assumption of a lessee's preexisting lease obligations
    - Rent holidays
    - Other reimbursements of lessee costs
    - Reductions of interest or principal charges by the lessor

Termination penalties (lessee only)

- If the lease term reflects a lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause, then any penalty associated with that termination option should be included in the lease payments.

Purchase Options

- If the lease includes an option to purchase the leased asset at the end of the lease term, and the lessor is reasonably certain to exercise that option, then the purchase option price should be included in the lease payment calculation.
- If the lease has an agreement for the lessee to purchase the leased asset at the end of the lease term *without* a termination option, then it is not a GASB 87 lease, but is rather a financed purchase of an asset.

  Example: A state agency enters into 5 year lease agreement for a copier with a purchase option for $500 at the end of the lease. The agency is reasonably certain that they will purchase the copier, so $500 is included in the lease payment calculation.

Variable Payment Types for Payable and Revenue Leases

- **Based on an Index or Rate:** payments are based on set common rates or an index, such as the Consumer Price Index.
  Example: A state agency signs a contract with a vendor for office space. The rent is $3,000 per month and increases annually with the Consumer Price Index. The variable payments include the $3,000 monthly rent, plus the Consumer Price Index rate as of the beginning of the lease. The Lease Payment would be calculated using the known rate at the start of the Lease.
- **Fixed in Substance:** variable payments that have a minimum payment.

Example: A state agency signs a contract with a vendor for printer supplies. The contract states the agency pays $0.01 a page or $500 a month, whichever is greater. The minimum payment of $500 is a fixed in substance payment. The rest is variable and is not part of the lease payment calculation.

- **Based on Usage or Future Performance:** payments that depend on future performance, such as reaching a certain threshold or usage.
  Example: A state agency signs a contract with a vendor to rent an excavator for $50 per hour. Each excavator rented in the past 10 years was used for over 500 hours per year. A new construction project requires double the amount of excavator work needed over the course of the contract. The variable payment amount to be included in the measurement is $0 since payments are based on disincentives future usage.

Residual Value Guarantees (RVGs)

- A residual value guarantee is a guarantee made by the lessee to the lessor that the value of the underlying asset will be at least a specific amount at the end of the lease.

  Example: A State agency enters into a lease agreement for a vehicle for 3 years and both parties agree to a RVG. If at the end of the lease term, the vehicle's fair value falls below $1000, then the State agency will pay the difference between $1000 and the fair value at the end of the lease term. At the beginning of the lease, the State agency expects the fair value of the vehicle to be $1000. Therefore, the State agency includes an amount of $0 in the lease payments when calculating the lease liability. A year later, the State agency determines that the fair value of the vehicle will be $600. The State agency must then re-measure the lease liability to include the $400 (the difference between the RVG and current fair value) within the lease payments.

Next Steps

Effective July 1, 2021, the threshold for GASB 87 leases is **$500,000**. Beginning fiscal year 2022, agencies must report all GASB 87 leases that meet the threshold to the GAO, ACFR (Annual Comprehensive Financial Report) Team. Agencies will need to provide lease information for both the beginning balance at 7-01-2021 and ending balance at 6-30-2022. To capture this information, GAO has developed a Decision Form and Collection Template for both the State as a Lessee and Lessor. Please complete requests for information and input timely and use the provided resources for additional information. If you have any questions, please contact GAOGASB87@azdoa.gov.