GOVERNMENTAL ACCOUNTING STANDARDS BOARD

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February 2015

THE GASB'S LEASE ACCOUNTING PROPOSALS: WHAT FINANCIAL STATEMENT USERS NEED TO KNOW

The primary goal of the Governmental Accounting Standards Board (GASB) is to develop high-quality standards of accounting and financial reporting for state and local governments. High-quality standards lead to information that municipal bond analysts, legislative fiscal staff, taxpayer associations, and others need for making important decisions, evaluating the financial health of governments, and assessing government accountability. The GASB periodically reviews its existing standards to ensure they continue to achieve these objectives effectively.

The GASB is proposing significant improvements to its standards for accounting for and reporting on government leasing transactions. Many governments enter into numerous leases each year, both as a lessee and a lessor, involving assets as varied as office equipment, vehicles, and buildings. The proposal would result in fundamental changes in how leases are accounted for, most notably eliminating the present distinction between capital leases and operating leases in favor of treating all leases (except short-term leases) as financings.

The proposed changes are based on extensive deliberations by the Board following research conducted by the GASB staff. The GASB believes the proposed changes are necessary for several reasons:

- The existing standards on leases are based primarily on private sector standards that were issued over the last 40 years, and which are currently being revised by the Financial Accounting Standards Board and the International Accounting Standards Board.
- The existing standards have been criticized for allowing the structuring of lease agreements so that they are classified as operating leases. Capital leases lead to reporting of long-term liabilities for lessees, but operating leases do not.
- Governmental accounting and financial reporting has changed significantly since the existing lease standards were issued, most notably through the introduction of accrual-based government-wide financial statements.
- The GASB has continued to develop the basic concepts that are the foundation of its standards setting, especially the concepts regarding what constitutes an asset and a liability.

The proposed changes to the standards are made in a document called a Preliminary Views, which is intended to obtain public feedback prior to developing new draft standards for public review. The Preliminary Views, *Leases*, was issued in November 2014 and is available to download free from the GASB website. This article addresses the major provisions of the proposal.

HOW LEASES ARE ACCOUNTED FOR NOW

The existing lease standards provide criteria for distinguishing between operating and capital leases. A lease is a capital lease if it meets *any* of the following criteria:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains an option to purchase the leased property at a bargain price.
3. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
4. The present value of rental or other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property less any investment tax credit retained by the lessor.

This distinction is important because the accounting for operating and capital leases is very different.

Capital Leases

For a *capital lease*, in accrual-based financial statements a government lessee (the government paying for the right to use the asset) reports the leased asset as a capital asset, balanced by a long-term liability—a capital lease obligation payable. The amount of the asset and liability is equal to the present value of the future lease payments. The government lessor (the government whose asset is being leased) recognizes a long-term lease receivable related to the future lease payments and removes the asset from its financial statements.

In the governmental funds, which report on a modified accrual basis, capital assets and long-term liabilities are not reported. Rather, when a lease is entered into the government reports an expenditure equal to that present value amount and an other financing source—capital lease agreement.

Operating Leases

Unlike capital leases, no capital assets, long-term receivables, or long-term liabilities are reported at the inception of an operating lease. Rather, payments made or received (or due to be made or received) related to operating leases are reported each year as expenses/expenditures and revenues, respectively.

THE GASB PROPOSAL

The GASB proposes to define a lease as "a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction." Any transaction meeting the definition would be subject to the proposed standards. Most of the time, a lease would involve a government (the *lessee*) paying for the right to use another entity's asset, or a government (the *lessor*) being paid by another entity (including other governments) for the right to use one of the government's assets. Sometimes both the lessee and lessor are governments.

The GASB's lease accounting proposal is based on the premise that *all leases are financings*. (An exception would be short-term leases, which are discussed later.) In other words, in every lease the lessee effectively is borrowing (from the lessor) to pay for the use of an asset, usually a capital asset. That borrowing is repaid, with interest, through the lease payments that the lessee makes to the lessor. A transaction involving the leasing of a building has the same economic impact on the lessee (and the lessor) as if the lessee had sold municipal bonds to the lessor, or the lessor had loaned money to the lessee, in order to finance the acquisition of the right to use the building.

Accounting by Lessee Governments

Except for short-term leases, a lessee would report in its accrual financial statements (such as the government-wide statement of net position) a capital asset and long-term liability related to the lease, just as it does now for a capital lease. However, rather than reporting the tangible asset (or a portion of the tangible asset) that is leased, the lessee would report an *intangible lease asset* that represents the lessee's right to use the leased asset. (See Chapter 4 of the Preliminary Views and the summary chart on the next page.)

The long-term lease payable would be measured as the present value of the payments under the provisions of the lease. The intangible lease asset would equal the lease liability plus any prepayments and certain initial direct costs.

In subsequent years, the lessee would report interest expense on the lease liability, payments that reduce the lease liability outstanding, and amortization expense that reduces the intangible lease asset over the term of the lease, similar to depreciation.

There would be no change to the existing accounting in governmental funds.

Accounting by Lessor Governments

Except for short-term leases, a lessor would report in its accrual financial statements a long-term lease receivable and a deferred inflow of resources. (See Chapter 5 and the summary chart on the next page.) The reporting of the deferred inflow reflects the fact that the lease revenues are related to future periods. The lessor would *not* remove the leased asset from its financial statements, as under the existing capital lease standards, because of the complexity of separately measuring (1) the portion of the rights impounded in the asset that has been transferred to the lessee and (2) the portion that has been retained.

The lease receivable would equal the present value of the payments under the provisions of the lease. The deferred inflow would equal the lease receivable plus any prepayments received that relate to future periods.

In subsequent years, the lessor would recognize revenue that is part interest on the lease receivable and part principal payment. The recognition of revenue would reduce the deferred inflow each year.

There would be no change to the existing accounting in governmental funds.

Initial Reporting of the Lease			
	Assets	**Liability**	**Deferred Inflow**
Lessee	Intangible asset (right to use leased asset)—value of lease liability plus prepayments and initial direct costs that are ancillary to place asset in use	Present value of future lease payments (including fixed payments, variable payments based on index or rate, probably residual guarantees)	Not Applicable
Lessor	• Lease receivable (generally including same items as lessee liability) • Continue to report leased asset	Not Applicable	Equal to lease receivable plus any cash received up front related to future periods

Subsequent Reporting of the Lease			
	Assets	**Liability**	**Deferred Inflow**
Lessee	Amortize over shorter of useful life or lease term	Reduce by lease payments (less amount of interest expense)	Not Applicable
Lessor	• Depreciate leased asset (unless indefinite life or required to be returned in its original or enhanced condition) • Reduce receivable by lease payments (less payment needed to cover accrued interest) • Amortize discount over term of the receivable	Not Applicable	Recognize revenue over the lease term on a systematic and rational basis

The Lease Term

In order to calculate the present value of the lease payments (for the purpose of measuring the lease-related assets and liabilities), it is necessary to know how long the lease will last—the lease *term*. (See Chapter 3.) The lease term is defined as the period during which a lessee has a noncancellable right to use an underlying asset (referred to as the noncancellable period). Many leases include options to extend the lease or to end it early:

- Periods covered by the lessee's option to extend the lease would be included in the lease term (and, thus, in the value of the lease-related assets and liabilities) only if it is *probable* (likely to occur) that the lessee will exercise the option.
- Periods covered by the lessee's option to terminate the lease would be included in the lease term only if it is probable that the lessee will *not* exercise the option.

It is common for government leases to include fiscal funding or cancellation clauses. Governments often are limited in how much debt they may have outstanding at any given time, or in their ability to incur long-term liabilities, including leases. These clauses allow government lessees to terminate a lease agreement on an annual basis if funds are not appropriated to make required payments. However, experience has shown that governments rarely, if ever, exercise these clauses. Therefore, the GASB is proposing to continue the practice of not reflecting fiscal funding or cancellation clauses in the lease term if the possibility of cancellation is remote.

Summary of Proposals

- All transactions meeting the definition of a lease (except for short-term leases) would be considered financings.
- Lessees would report an intangible asset related to the right to use the leased asset and a long-term lease payable.
- Lessors would report a long-term lease receivable and a deferred inflow of resources, and would continue to report the leased asset.
- In the governmental funds, governments would continue to account for leases (except for short-term leases) as they do now for capital leases.

Questions for Users about Accounting for Leases

1. *Do you agree or disagree with the GASB's proposals to eliminate the distinction between operating leases and capital leases? Why do you agree or disagree?*

2. *How would the proposals for* ***lessee*** *accounting affect either or both of the following, if at all:*

a. *The usefulness of the information to the analyses you perform, the work you do, or the decisions you make?*
b. *Your ability to assess a government's accountability?*

> **3.** *How would the proposals for **lessor** accounting affect either or both of the following, if at all:*
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> a. *The usefulness of the information to the analyses you perform, the work you do, or the decisions you make?*
> b. *Your ability to assess a government's accountability?*

THE EXCEPTION FOR SHORT-TERM LEASES

The GASB is proposing an exception to the accounting provisions described thus far for *short-term leases*. A short-term lease would be defined as "a lease that, at the beginning of the lease, has a maximum possible term under the contract of 12 months or less, including any options to extend." This exception is based on the idea that the financing component is less significant for a relatively short lease. For this reason, the GASB believes that the benefits to financial statement users of accounting for short-term leases using the approach described in the prior sections on lessee and lessor accounting would not be significant enough to justify the cost to governments.

Lessees would report their payments on short-term leases as expenses and expenditures. Lessees would *not* recognize an intangible asset or long-term liability.

Lessors would report the lease payments on short-term leases as revenues. Lessors would *not* report a receivable or deferred inflows of resources.

> **Questions for Users about the Exception for Short-Term Leases**
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> **4.** *Do you agree or disagree with the GASB's proposals to exclude short-term leases from the accounting requirements for other leases? Why do you agree or disagree?*
>
> **5.** *How would the proposal for short-term lease accounting affect either or both of the following, if at all:*
>
> a. *The usefulness of the information to the analyses you perform, the work you do, or the decisions you make?*
> b. *Your ability to assess a government's accountability?*

Subleases and Leaseback Transactions

The GASB's general view is that individual components of a complex transaction generally should be accounted for separately, rather than combined or netted against one another in the financial statements.

Subleases

The GASB is proposing that *subleases of a leased asset should be accounted for as a separate transaction from the original lease.* (See Chapter 8.) In the sublease transaction, the lessee in the original lease is now the lessor; transactions in which a government is a lessee should be reported separately from transactions in which it is a lessor.

Sale-leaseback transactions

In a sale-leaseback transaction, one entity sells a capital asset to another entity, which in turn leases the capital asset back to the seller. An actual sale of a capital asset (as described in the proposal) is necessary to consider a transaction a sale-leaseback. As with subleases, the GASB is proposing that *the sale of the capital asset and its subsequent lease would be accounted as separate transactions.* Any gain or loss on the sale would be deferred over the term of the lease, rather than immediately reported as an increase or decrease in net position, respectively.

Sale-leaseback transactions sometimes involve an *off-market* sales price or lease payments. In other words, the sale price is significantly higher or lower than the fair value of the asset, or the lease payments are significantly higher or lower than prevailing market rates. If the transaction is off-market, the GASB is proposing that a government would account for the difference between the transaction amounts and market amounts as follows:

- If the sales price or lease payments are *higher* than market, a government seller-lessee of the asset would separately report the difference as a *loan* from the buyer-lessor. The higher-than-market lease payments made by the seller-lessee include both the fee for using the asset and the repayment of the additional amount loaned.
- If the sales price or lease payments are *lower* than market, a government seller-lessee of the asset would reflect the difference in its measurement of the intangible asset representing the right to use the leased asset. A government buyer-lessor would reflect the difference in its measurement of the deferred inflow of resources.

Above-Market Sale-Leaseback	
Sale	Sales price = fair market value of capital asset + loan from the *buyer*
Leaseback	Lease payments = fair market lease payments + payments on the loan

Below-Market Sale-Leaseback	
Seller-Lessee	• Intangible asset = present value of *market* lease payments • Lease liability = present value of the *actual below-market* lease payments
Buyer-Lessor	• Lease receivable = present value of the *actual below-market* lease payments • Deferred inflow = present value of *market* lease payments

The seller-lessee would be required to disclose information about the provisions of the sale-leaseback transaction in the notes to the financial statements.

Lease-leaseback transactions

In a lease-leaseback transaction, one entity leases a capital asset to another entity, which in turn leases the capital asset back. In other words, each party to the transaction is both a lessor and a lessee. Therefore, unlike the approach for subleases and sale-leaseback transactions, the GASB is proposing that *the components of a lease-leaseback transaction would be netted against one another* because the counterparties are the same. However, a government would be required to disclose the gross amounts of the lease and leaseback.

Summary of Proposals

- Subleases would be accounted for separately from the original lease transaction.
- The sale and lease in a sale-leaseback would be accounted for as separate transactions.
- The leases in a lease-leaseback transaction would be reported net.

Questions for Users about Subleases and Leaseback Transactions

6. *Do you agree or disagree with the GASB's proposals for subleases, sale-leasebacks, and lease-leasebacks? Why do you agree or disagree?*

7. *How would the proposal for subleases, sale-leasebacks, and lease-leasebacks affect either or both of the following, if at all:*

a. *The usefulness of the information to the analyses you perform, the work you do, or the decisions you make?*
b. *Your ability to assess a government's accountability?*

DISCLOSURES

The GASB is proposing that a *lessee* would disclose the following about its lease transactions:

a. A general description of its leasing arrangements, including how variable lease payments are determined
b. The total amount of assets recorded under leases (separately from owned assets), and the related accumulated amortization
c. The amount of assets recorded under leases by major classes of assets underlying its lease assets
d. The amount of expense recognized for the period for variable lease payments not previously included in the lease liability
e. The amount of expense recognized for the period for other payments, such as residual value guarantees or penalties, not previously included in the lease liability
f. A schedule of future lease payments to be made in each of the subsequent five years and in five-year increments thereafter, with reconciliation to the lease liability for the discount (that represents interest)
g. Commitments under leases (other than short-term leases) that have not yet begun

h. The components of any net impairment loss (gross impairment loss less change in lease liability) recognized on the lease asset during the period.

The GASB is proposing that a *lessor* would disclose the following about its lease transactions:

a. A general description of its leasing arrangements, including how variable lease payments are determined
b. The cost (and carrying amount, if different) of assets on lease or held for leasing, by major classes of assets, and the amount of accumulated depreciation
c. The total amount of revenue (including lease revenue and interest revenue) recognized in the reporting period from leases
d. The amount of revenue recognized in the reporting period for variable lease payments and other payments not previously included in the lease receivable, including revenue related to residual value guarantees and termination penalties
e. A schedule of the future lease payments that are included in the lease receivable for each of the subsequent five years and in five-year increments thereafter, with reconciliation to the lease receivable for the discount (that represents interest)
f. If the government has issued debt for which the principal and interest payments are secured by the lease payments, the existence, terms, and conditions of options by the lessee to terminate the lease.

Questions for Users about Disclosures

8. *Do you agree or disagree with the GASB's proposals for disclosures by lessees and lessors? Why do you agree or disagree?*

9. *What other information about leases, if any, do you need to be disclosed? How would you use that information?*

10. *How would the proposal for disclosures affect either or both of the following, if at all:*

a. *The usefulness of the information to the analyses you perform, the work you do, or the decisions you make?*

b. *Your ability to assess a government's accountability?*

WHAT INFORMATION DOES THE GASB NEED TO PROCEED WITH THIS PROJECT?

When the GASB sets standards, a crucial part of its "due process" activities is the publication of documents for public discussion and comment. The GASB relies on the comments of the people who prepare and audit financial statements to assess the technical accuracy and appropriateness of potential approaches to addressing accounting and financial reporting issues.

The users of financial information, on the other hand, are in the best position to help the GASB understand whether or not the information that would result from the proposals would be useful for fulfilling their need for governmental financial information. The substance of the comments from each of the GASB's constituents is more important to the GASB's deliberations than the total number of people for or against a certain proposal. A Preliminary Views is not an opinion poll, and the GASB's ultimate decisions are not necessarily those with the most popular support.

HOW CAN YOU SHARE YOUR OPINIONS WITH THE GASB?

It is essential to the Board to receive feedback from users like you, in response to the questions presented above. The GASB is conducting a webinar about its leases proposals specifically for users of governmental financial information at **1:00–2:00 p.m. EST on March 4, 2015.** The webinar will include time to answer questions from the viewers and will be followed by a brief survey asking for your feedback on the proposal. You can register to view the webinar by clicking here.

Following the live broadcast on March 4, a recording of the webinar will be available on the GASB website. You will be able to complete the survey after watching the webinar.

If you would like to submit written comments to the GASB about the views expressed in this document, there are two ways you may do so:

- By email—send your comments to director@gasb.org
- By traditional mail—include your comments in a letter and mail to:

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Submissions are requested by March 6, 2015.