STATE OF IOWA
DEPARTMENT OF ADMINISTRATIVE SERVICES

Lease Policy - Lessee

GASB Statement 87, *Leases,* (GASB 87) was effective **beginning July 1, 2021** (FY 2022) and was amended by GASB Statements 91 – *Conduit Debt Obligations*, 94 – *Public-Private and Public-Public Partnerships and Availability Payment Arrangements*, and 96 – *Subscription-Based Information Technology Arrangements* (SBITA).

GASB 87 established a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. GASB 87 superseded prior guidance in which leases were classified as either capital or operating leases depending on whether the lease met any of four tests. GASB 87 requires a lessee to recognize a lease liability and an intangible right-to-use lease asset (lease asset).

A. Lease Determination:

Step 1: Review the potential lease contract and determine if it meets the lease definition:

Lease definition:

GASB 87 defines a lease 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. (GASB 87, paragraph 4)

To determine whether a contract **conveys control of the right to use** the underlying asset, a government should assess whether it has both of the following: (a) the right to obtain the present service capacity from use of the underlying asset as specified in the contract, and (b) the right to determine the nature and manner of use of the underlying asset as specified in the contract. (GASB 87, paragraph 5)

Leases include contracts that, although not explicitly identified as leases, meet the definition of a lease. This definition excludes contracts for services, except those contracts that contain both a lease component and a service component. (GASB 87, paragraph 6)

As used above in the definition of a lease, a **nonfinancial asset** is an asset that is not a financial asset (as defined in GASB 72). Nonfinancial assets include real property, such as land, buildings, vehicles, and equipment. (GASB 87, paragraph 7)

The difference between exchange and **exchange-like** transactions is a matter of degree. In contrast to a "pure" exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal. A $1 contract for the right to use another entity's building would not be considered an exchange-like transaction because each party does not receive or give up essentially equal value or not quite equal value. (GASB 87, footnote 1; Implementation Guide 2019-3, Q&A 4.1)

The following are not GASB 87 leases and; therefore, are excluded from the scope of this policy:
(GASB 87, paragraph 8; modified by GASB 91, 94 and 96)

(a) Leases of intangible assets, including rights to explore for or to exploit natural resources such as oil, gas, and minerals and similar nonregenerative resources; licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights; and licensing contracts for computer software.
(b) Leases of biological assets, including timber, living plants, and living animals.
(c) Leases of inventory.
(d) Public-private and public-public partnerships (PPP) if (1) existing assets of the transferor are not the only underlying PPP assets, (2) improvements are required to be made by the operator to those existing assets of the transferor as part of the PPP arrangement, or (3) the PPP meets the definition of a service concession arrangement in GASB 94, paragraph 6.
(e) Contracts that are in the scope of GASB 96, *Subscription-Based Information Technology Arrangements* (SBITA).
(f) Arrangements associated with conduit debt obligations as described in GASB 91, paragraph 18.
(g) Supply contracts, such as power purchase agreements.

Step 2: Calculate the lease term:

Lease term:

GASB 87 defines lease term as the period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period), plus the following periods, if applicable: (GASB 87, paragraph 12)

(a) Periods covered by a lessee's option to extend the lease if it is reasonably certain that the lessee will exercise that option.
(b) Periods covered by a lessee's option to terminate the lease if it is reasonably certain that the lessee will not exercise that option.
(c) Periods covered by a lessor's option to extend the lease if it is reasonably certain that the lessor will exercise that option.
(d) Periods covered by a lessor's option to terminate the lease if it is reasonably certain that the lessor will not exercise that option.

Periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party (or if both parties have to agree to extend) are cancelable periods and are excluded from the lease term. For example, a rolling month-to-month lease, or a lease that continues into a holdover period until a new lease contract is signed, would not be enforceable if both the lessee and the lessor have an option to terminate and, therefore, either could cancel the lease at any time. Provisions that allow for termination of a lease due to (1) purchase of the underlying asset, (2) payment of all sums due, or (3) default on payments, are not considered termination options.

A fiscal funding clause or cancellation clause allows lessees to cancel a lease, typically on an annual basis, if the government does not appropriate funds for the lease payments. This type of clause should affect the lease term only if it is reasonably certain that the clause will be exercised. (GASB 87, paragraph 13)

At the commencement of a lease, the lessee should assess all factors relevant to the likelihood that the lessee or the lessor will exercise options identified above to extend or terminate the lease, whether these factors are contract based, underlying asset based, market based, or government specific. The assessment will often require the consideration of a combination of these interrelated factors. Examples of factors to consider include, but are not limited to, the following: (GASB 87, paragraph 14)

(a) A significant economic incentive, such as contractual terms and conditions for the optional periods that are favorable compared with current market rates.
(b) A significant economic disincentive, such as costs to terminate the lease and sign a new lease.
(c) The history of exercising options to extend or terminate.
(d) The extent to which the asset underlying the lease is essential to the provision of services.

Lessees should reassess the lease term only if one or more of the following occur: (GASB 87, paragraph 15)

(a) The lessee or lessor elects to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would not exercise that option.
(b) The lessee or lessor elects not to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would exercise that option.
(c) An event specified in the lease contract that requires an extension or termination of the lease takes place.

Step 3: Threshold for recognition of lease liabilities and right-to-use lease assets:

The State of Iowa will use the same threshold for both a lessee's lease liability and lease asset.

All State Departments and Universities will apply a $50,000 threshold, except the University of Iowa will apply a $1 million threshold, beginning in FY2024.

As a general rule, the threshold should be applied to individual lease contracts. Further, if a contract contains a non-lease component, this portion should not be included in the calculation to determine if a lease contract meets the threshold. See Contracts with Multiple Components under C: Other Contractual Elements.

- Example: Department A has a lease contract with a 4-year noncancelable period and a 2-year option to extend the lease. Department A has determined it has a 6-year lease term because it expects to exercise the 2-year option to extend the lease. Department A pays $1,500 monthly to the lessor ($1,250 for rent of the office space and $250 for maintenance). The State's estimated incremental borrowing rate was determined to be 1.50%. This lease meets the $50,000 threshold as follows:

  $1,250 x 12 months x 6 years @ 1.50% = $86,124.97 initial lease liability.

<u>Step 4: Review the lease contract to determine if it meets the short-term lease exception:</u>

<u>Short-term leases:</u>

GASB 87 defines a short-term lease as a lease that, at commencement of the lease term, has a <u>maximum possible term</u> under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised. For a lease that is cancelable by both the lessee and the lessor, such as a rolling month-to-month lease or a year-to-year lease, the maximum possible term is the noncancelable period, including any notice periods. (GASB 87, paragraph 16; Implementation Guide 2019-3, Q&A 4.19)

- Example 1: A department enters into a lease with a lessor for 16 months. The department can cancel the lease at any time after six months. The lessor does not have the option to cancel the lease. As defined above, cancelable periods are periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party. In this example, because only the lessee has the right to cancel, the maximum possible term of this lease is 16 months; and therefore, this is not a short-term lease. (Implementation Guide 2019-3, Q&A 4.19)
- Example 2: A department enters into a 12-month noncancelable lease in which the lessee has options to renew for 12 months at a time, up to 49 times. GASB 87 requires the maximum possible term of a short-term lease to be 12 months or less, including any options to extend. As a result, the presence of lease renewal options, regardless of their probability of being exercised, means that this lease does not meet the definition of a short-term lease. (Implementation Guide 2019-3, Q&A 4.17)
- Example 3: A department enters into a lease with a 6-month noncancelable period and an option to extend for another 12 months after the noncancelable period. The department is not reasonably certain that it will exercise the option to extend, and therefore, assesses the lease term as 6 months. Because GASB 87 states that a short-term lease has a maximum possible term of 12 months (or less), including any options to extend, regardless of probability of being exercised, this lease is not a short-term lease. Therefore, the lessee should report a lease liability and a lease asset; however, the lease term would only be 6 months. (Implementation Guide 2019-3, Q&A 4.18)

When a lessee has a lease contract that meets the definition of a short-term lease, it should not report a lease asset or a lease liability. Instead, lessees should recognize short-term lease payments as outflows of resources (i.e. expenses) based on the payment provisions of the lease contract. A lessee should recognize an asset (i.e. prepaid expense) if rental payments are made in advance. Further, a lessee should report a liability for rent that is due on or before June 30th, when payment will not be made until after June 30th. (GASB 87, paragraph 17)

Step 5: Review the contract to determine if it is a financed purchase:

Contracts that transfer ownership (financed purchases):

A contract that (a) transfers ownership of the underlying asset to the lessee by the end of the contract and (b) does not contain termination options (as defined above), but that may contain a fiscal funding or cancelation clause that is not reasonably certain of being exercised, should be reported as a financed purchase (not a lease) of the underlying asset by the lessee or a sale of the asset by the lessor. (GASB 87, paragraph 19)

- Example 1: A vendor installs equipment in a department's building to increase energy efficiency. The department will own the equipment at the end of the agreement, and the contract does not contain a termination clause. Because title to the equipment transfers to the department by the end of the contract, the transaction is not accounted for as a lease for financial reporting purposes, instead it is reported as a financed purchase. (Implementation Guide 2019-3, Q&A 4.21)
- Example 2: A school district leases computers. At the end of the lease term, students are given the option to purchase their computers from the school district. Regardless of whether the students purchase their computers, the school district is required to purchase all computers from the lessor. The school district does not have a termination option. One criterion of a financed purchase is that the contract transfers ownership of the underlying asset to the lessee by the end of the contract. In this example, the lessee is the school district, not the students. This contract transfers ownership of the computers because the purchase by the school district is required. As a result, this transaction should be reported as a financed purchase, not a lease, for financial reporting purposes. (The sale of computers to the students is a separate transaction.) (Implementation Guide 2019-3, Q&A 4.22)

B. Lease Liability and Right-to-Use Lease Asset Calculations:

Step 6: Lease liability recognition and measurement:

Under GASB 87, lease contracts contain both principal and interest components. Therefore, payment schedules contained in lease contracts include principal and interest components. In general, the values of a lease liability and lease asset are derived from the present value of the payments expected to be made over a lease term.

At commencement of a lease term, a lessee should recognize a lease liability and an intangible right-to-use lease asset (a capital asset hereinafter referred to as a lease asset), except for short-term leases (Step 4) and contracts that transfer ownership (Step 5). (GASB 87, paragraph 20)

Lease Liability:

A lessee should measure the lease liability at the present value of payments expected to be made during the lease term (if required by the lease contract), including: (GASB 87, paragraph 21)

(a) Fixed payments
(b) **Variable payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the commencement of the lease term
(c) Variable payments that are fixed in substance
(d) Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees
(e) The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option
(f) Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause
(g) Any lease incentives receivable from the lessor
(h) Any other payments that are reasonably certain of being required based on an assessment of all relevant factors

Variable payments based on future performance of the lessee or usage of the underlying asset should not be included in the measurement of the lease liability. Instead, those variable payments should be recognized as expenses in the period in which the obligation for those payments is incurred. However, any component of those variable payments that is fixed in substance should be included in the measurement of the lease liability. (GASB 87, paragraph 22)

- Example: A school district leases buses for two years and is required to make variable payments based on the number of miles driven. There is no minimum payment requirement stated in the lease agreement. The school district is reasonably certain of the minimum number of miles that will be driven based on established routes. As noted above, these are variable payments based on future usage of the underlying asset. Therefore, these variable payments should not be included in the calculation of the lease liability. (Implementation Guide 2019-3, Q&A 4.28)

The future lease payments should be discounted using the interest rate the lessor charges the lessee, which may be the interest rate implicit in the lease. If the interest rate cannot be readily determined by the lessee, the lessee's estimated incremental borrowing rate (an estimate of the interest rate that would be charged for borrowing the lease payment amounts during the lease term) should be used. (GASB 87, paragraph 23)

- When departments are unable to determine an interest rate from a lease contract and do not have their own estimated incremental borrowing rate, they should use the estimated incremental borrowing rate calculated by the GAAP Team. The department should use the same estimated incremental borrowing rate for the duration of a lease's term. The rate calculated annually by the GAAP Team will be applicable for all leases entered into in a fiscal year.

In subsequent years, the lessee will calculate the amortization of the discount on the lease liability and report that amount as interest expense for the period. Payments should first be applied to accrued interest payable and then to the lease liability. (GASB 87, paragraph 24)

Step 7: Remeasurement of lease liability:

The lessee should remeasure the lease liability in subsequent fiscal years if one or more of the following changes have occurred on or before June 30th of the fiscal year and the changes individually or in the aggregate are expected to significantly affect the amount of the lease liability since the previous measurement: (GASB 87, paragraph 25)

(a) There is a change in the lease term.
(b) An assessment of all relevant factors indicates that the likelihood of a residual value guarantee being paid has changed from reasonably certain to not reasonably certain, or vice versa.
(c) An assessment of all relevant factors indicates that the likelihood of a purchase option being exercised has changed from reasonably certain to not reasonably certain, or vice versa.
(d) There is a change in the estimated amounts for payments already included in the measurement of the lease liability, except that a lease liability is not required to be remeasured solely for a change in an index or rate used to determine variable payments. (GASB 87, paragraph 26)
(e) There is a change in the interest rate the lessor charges the lessee, if used as the initial discount rate.
(f) A contingency, upon which some or all of the variable payments that will be made over the remainder of the lease term are based, is resolved such that those payments now meet the criteria for measuring the lease liability as described in Step 6. For example, an event occurs that causes variable payments that were contingent on the performance or use of the underlying asset to become fixed payments for the remainder of the lease term.

If a lease liability is remeasured for any of the changes described in Step 7, the liability also should be adjusted for any change in an index or rate used to determine variable payments if that change in the index or rate is expected to significantly affect the amount of the liability since the previous measurement. A lease liability is not required to be remeasured solely for a change in an index or rate used to determine variable payments. (GASB 87, paragraph 26)

The lessee should update the discount rate as part of the remeasurement if one or both of the following changes have occurred and the changes individually or in the aggregate are expected to significantly affect the amount of the lease liability: (GASB 87, paragraph 27)

(a) There is a change in the lease term.
(b) An assessment of all relevant factors indicates that the likelihood of a purchase option being exercised has changed from reasonably certain to not reasonably certain, or vice versa.

A lease liability is not required to be remeasured, nor is the discount rate required to be reassessed, solely for a change in the lessee's incremental borrowing rate. (GASB 87, paragraph 28)

Step 8: Right-to-use lease asset classifications:

The lessee is required to disclose the amount of lease assets (and the related amortization) by major classes of underlying assets, separately from other capital assets. (GASB 87, paragraph 37)

At a minimum, the following major classes of underlying assets for lease assets will be disclosed in the ACFR. (Please contact the GAAP Team if you believe you have a lease asset that does not fit into one of these categories so that we can determine an appropriate category.)

- Leased buildings (including parking ramps, partial buildings)
- Leased machinery, equipment & vehicles
- Leased land

Step 9: Right-to-use lease asset measurement and amortization for lessees:

Measurement: A lessee should initially measure the lease asset as the sum of the following: (GASB 87, paragraph 30)

(a) The amount of the initial measurement of the lease liability (see Step 6)
(b) Lease payments made to the lessor at or before the commencement of the lease term, less any lease incentives received from the lessor at or before the commencement of the lease term
(c) Initial direct costs that are ancillary charges necessary to place the lease asset into service

Amortization: A lease asset should be amortized using the straight-line method over the shorter of the lease term or the useful life of the underlying asset (except if the lessee is reasonably certain a **purchase option** will be exercised). The amortization of a lease asset should be reported as amortization expense. (GASB 87, paragraph 31)

- At a minimum, amortization should be calculated on a monthly basis. It is acceptable to be more precise and calculate amortization on a daily basis.

If a lease contains a **purchase option** that the lessee has determined is reasonably certain of being exercised, the lease asset should be amortized over the useful life of the asset. In this circumstance, if the underlying asset is nondepreciable (i.e. land) the lease asset should not be amortized. (GASB 87, paragraph 32)

Remeasurement: A lease asset generally should be adjusted by the same amount as the corresponding lease liability when that liability is remeasured based on Step 7. (GASB 87, paragraph 33)

Step 10: Current financial resources measurement focus:

If a lease is expected to be paid from a governmental fund (general fund, special revenue fund, capital projects fund or permanent fund), the lease should be accounted for consistent with governmental fund accounting principles. (GASB 87, paragraph 35)

An expenditure and other financing source should be reported in the period the lease is initially recognized. The expenditure and other financing source should be measured as discussed in the lease liability section above (Steps 6 & 7). Subsequent governmental fund lease payments should be accounted for consistent with principles for debt service payments on long-term debt. (GASB 87, paragraph 36)

C. Other Contractual Elements:

Lease Incentives: 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. A lease incentive is equivalent to a rebate or discount and includes assumption of a lessee's preexisting lease obligations to a third party, other reimbursements of lessee costs, rent holidays, and reductions of interest or principal charges by the lessor. (GASB 87, paragraph 61)

Lease incentives reduce the amount that a lessee is required to pay for a lease. Lease incentives that provide payments to, or on behalf of, a lessee at or before the commencement of a lease term are included in initial measurement by directly reducing the amount of the lease asset (see Step 9). Lease incentive payments to be provided after the commencement of the lease term should be accounted for by lessees as reductions of lease payments for the periods in which the incentive payments will be provided. Those payments should be measured by lessees consistently with the lessee's lease liability (see Step 6). Accordingly, lease incentive payments to be provided after the commencement of the lease term are included in initial measurement and any remeasurement if they are fixed or fixed in substance, whereas variable or contingent lease incentive payments are not included in initial measurement. (GASB 87, paragraph 62)

Contracts with Multiple Components: Lessees may enter into contracts that contain multiple components, such as a contract that contains both a lease component and a non-lease component, or a lease that contains multiple underlying assets. (GASB 87, paragraph 63)

If a lessee enters into a contract that contains both a lease component (such as the right to use a building) and a non-lease component (such as maintenance services for the building), account for the lease and non-lease components as separate contracts. (GASB 87, paragraph 64)

- Exception: If a contract does not include prices for individual components, use professional judgment to determine the best estimate for allocating the contract price to the components, maximizing the use of observable information.
- If it is not practicable to determine a best estimate for some or all components in a contract, account for those components as a single unit. (GASB 87, paragraph 67)

If a lease involves multiple underlying assets and the assets have different lease terms, account for each underlying asset as a separate lease component. (GASB 87, paragraph 65)

Contract Combinations: Contracts that are entered into at or near the same time with the same counterparty should be considered part of the same contract if either of the following criteria is met:

(a) The contracts are negotiated as a package with a single objective.
(b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract. (GASB 87, paragraph 69)

If multiple contracts are determined to be part of the same contract, evaluate that contract in accordance with the Contracts with Multiple Components section above. (GASB 87, paragraph 70)

Lease Modifications: A lease contract may be amended while the contract is in effect. Examples of amendments include changing the contract price, lengthening or shortening the lease term, and adding or removing an underlying asset. An amendment should be considered a lease modification unless the lessee's right to use the underlying asset decreases, in which case the amendment should be considered a partial or full lease termination. (GASB 87, paragraph 71)

Account for an amendment that results in a modification to a lease contract as a separate lease (that is, separate from the most recent lease contract before the modification) if both of the following conditions are met:

(a) 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 contract.
(b) The increase in lease payments for the additional lease asset does not appear to be unreasonable based on (1) the terms of the amended lease contract and (2) professional judgment. (GASB 87, paragraph 72)

Unless a modification is reported as a separate lease as provided in the paragraph above, a lessee should account for a lease modification by remeasuring the lease liability. The lease asset should be adjusted by the difference between the remeasured lease liability and the liability immediately before the lease modification. (GASB 87, paragraph 73)

Lease Terminations: The lessee should account for an amendment resulting in a decrease in the lessee's right to use the underlying asset (for example, the lease term is shortened or the number of underlying assets is reduced) as a partial or full lease termination. (GASB 87, paragraph 77)

A lessee generally should account for the partial or full lease termination by reducing the carrying values of the lease asset and lease liability, and recognizing a gain or loss for the difference. However, if the lease is terminated as a result of the lessee purchasing an underlying asset from the lessor, the lease asset should be reclassified to the appropriate class of owned asset. (GASB 87, paragraph 78)

Subleases: A sublease involves three parties: the original lessor, the original lessee (who also is the lessor in the sublease), and the new lessee. The original lessee should account for the original lease and the sublease as two separate transactions, as a lessee and a lessor, respectively. Those two separate transactions should not be offset against one another. The new lessee should apply the general lease guidance included in this policy. (GASB 87, paragraph 80)

- Exception: If your department entered into a sublease with another department for an asset that the other department leased from a third party, do not report the sublease. The department that pays the third party should record the entire lease agreement.

Intra-Entity Leases: Lease arrangements between the State of Iowa and its discretely presented component units (or between two discretely presented component units) should be treated in the same manner as any other lease in accordance with this policy. (GASB 87, paragraph 89)