# *Lease Policy - Lessor*

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 GASB 87 superseded prior guidance in which leases were classified as either capital or operating leases depending on whether the lease met any of four tests.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 lessor to recognize a lease receivable and deferred inflows of resources.

## 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 4.
(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 lessor 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.

Lessors 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 receivable and deferred inflows of resources:

The State of Iowa will use the same threshold for both a lessor's lease receivable and deferred inflows of resources.

**The threshold is $100,000.**

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 is a lessor 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 the 2-year option to extend the lease will be exercised. Department A receives $2,500 monthly from the lessee ($2,000 for rent of the office space and $500 for cleaning services). The State's estimated incremental borrowing rate was determined to be 1.50%. This lease meets the $100,000 threshold as follows:

  $2,000 x 12 months x 6 years @ 1.5% = $137,799.93 initial lease receivable.

**<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 lessor has a lease contract that meets the definition of a short-term lease, it should not report a lease receivable or deferred inflows of resources. Instead, lessors should recognize short-term lease payments as inflows of resources (i.e. revenue) based on the payment provisions of the lease contract. A lessor should recognize a liability (i.e. unearned revenue) if rental payments are received in advance. Further, a lessor should report an asset (i.e. rent receivable) for rent that is due on or before June 30th, when payment will not be received until after June 30th. (GASB 87, paragraph 18)

**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 Receivable and Deferred Inflows of Resources Calculations:

**Step 6: Lease receivable 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 initial value of a lease receivable and deferred inflows of resources is derived from the present value of the payments expected to be received over a lease term.

At commencement of a lease term, a lessor should recognize a lease receivable and deferred inflows of resources, except for short-term leases (Step 4), contracts that transfer ownership (Step 5), leases of assets that are **investments**, and **certain regulated leases**. (GASB 87, paragraph 40)

- If the underlying asset in a lease meets the requirements in GASB 72 to be reported as an **investment** measured at fair value, the lessor should not apply the recognition and measurement provisions of GASB 87. (GASB 87, paragraph 41)
- Certain leases are subject to external laws, regulations, or legal rulings. For example, the U.S. Department of Transportation and the Federal Aviation Administration regulate aviation leases between airports and air carriers and other aeronautical users. **Regulated leases** that meet the provisions of GASB 87, paragraph 43 should not apply these recognition and measurement provisions. Instead, lessors should recognize inflows of resources (revenues) based on the payment provisions of the lease contract and provide the disclosures required by GASB 87, paragraph 60 for these regulated leases. (GASB 87, paragraph 42-43)

<u>Lease Receivable:</u>

A lessor should measure a lease receivable at the present value of lease payments expected to be received during the lease term, reduced by any provision for estimated uncollectible amounts. A department should assume a lease receivable is collectible, unless there are known facts or circumstances that indicate otherwise. Include all of the following, if required by a lease, in the measurement of a lease receivable: (GASB 87, paragraph 44)

(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 <u>fixed in substance</u>
(d) **Residual value guarantee payments** that are <u>fixed in substance</u>
(e) Any lease incentives payment to the lessee

**Variable payments** based on future performance of the lessee or usage of the underlying asset should <u>not</u> be included in the measurement of the lease receivable. Rather, those variable payments should be recognized as inflows of resources (revenue) in the period to which those payments relate. However, any component of those variable payments that is <u>fixed in substance</u> should be included in the measurement of the lease receivable. (GASB 87, paragraph 45)

Amounts to be received under **residual value guarantees** (that are <u>not</u> fixed in substance) should be recognized as a receivable and inflow of resources (revenue) if, (a) a guarantee payment is required (as agreed in the lease) and (b) the amount can be reasonably estimated. Amounts to be received for the exercise price of a purchase option or penalty for lease termination should be recognized as a receivable and inflow of resources (revenue) when those options are exercised. (GASB 87, paragraph 46)

- Example: In addition to fixed payments, a lease contract includes provisions for variable payments based on future performance and for a residual value guarantee that did not initially meet the criteria for inclusion in the lease receivable (neither was fixed in substance). If those variable payments and the residual value guarantee subsequently meet the criteria for recognition, should the amounts be added to the existing lease receivable or be considered separate receivables? (Implementation Guide 2019-3, Q&A 4.48)

  Answer: When the variable payments and residual value guarantee meet the criteria for recognition, the amounts should be considered separate receivables (not part of the lease receivable), and an inflow of resources (revenue) should be recognized in the period to which those payments relate.

The future lease payments to be received should be discounted using the interest rate the lessor charges the lessee, which may be the interest rate implicit in the lease. (GASB 87, paragraph 47)

- Example: GASB 87, paragraph 47 requires a lessor to discount the future lease payments to be received using the interest rate the lessor charges the lessee. How should the lessor determine that rate? (Implementation Guide 2020-1, Q&A 4.15)

  Answer: If the lease contract contains a stated interest rate, the stated rate generally is the rate the lessor charges the lessee, and the lessor should use that rate. If there is no stated rate (or if the stated rate is not the rate the lessor charges the lessee), the lessor should determine whether the rate implicit in the lease can be estimated. If there is no stated rate (or if the stated rate is not the rate the lessor charges the lessee) and the implicit rate cannot be determined, the lessor may presume that it is recovering its cost associated with interest cost and use the lessor's own incremental borrowing rate as the discount rate.

In subsequent years, the lessor should calculate the amortization of the discount on the lease receivable and report that amount as interest revenue for the period. Payments should first be allocated to accrued interest receivable and then to the lease receivable. (GASB 87, paragraph 48)

## <u>Step 7: Remeasurement of lease receivable:</u>

The lessor should remeasure the lease receivable in subsequent fiscal years if one or more of the following changes have occurred on or before June 30th of the fiscal year <u>and</u> the changes individually or in the aggregate are expected to significantly affect the amount of the lease receivable since the previous measurement: (GASB 87, paragraph 49)

(a) There is a change in the lease term.
(b) There is a change in the interest rate the lessor charges the lessee.
(c) A contingency, upon which some or all of the variable payments that will be received over the remainder of the lease term are based, is resolved such that those payments now meet the criteria for measuring the lease receivable in Step 6. For example, an event occurs that results in variable payments that were contingent on the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term.

If a lease receivable is remeasured for any of the changes described in the previous paragraph, the receivable 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 receivable since the previous measurement. A lease receivable is <u>not</u> required to be remeasured solely for a change in an index or rate used to determine variable payments. (GASB 87, paragraph 50)

The lessor 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 receivable: (GASB 87, paragraph 51)

(a) There is a change in the lease term.
(b) There is a change in the interest rate the lessor charges the lessee.

If the discount rate is updated based on the above paragraph, the receivable should be remeasured using the revised discount rate.

## **<u>Step 8: Measurement and amortization of deferred inflows of resources:</u>**

<u>Measurement:</u> A lessor should initially measure the deferred inflows of resources as follows: (GASB 87, paragraph 53)

(a) The amount of the initial measurement of the lease receivable (Step 6)
(b) Lease payments received from the lessee at or before the commencement of the lease term that relate to future periods (for example, the final month's rent), less any lease incentives paid to, or on behalf of, the lessee at or before the commencement of the lease term.

<u>Amortization:</u> Deferred inflows of resources should be recognized as inflows of resources (revenues) in a systematic and rational manner over the term of the lease. (GASB 87, paragraph 54)

- At a minimum, inflows of resources (revenues) should be calculated and recognized on a monthly basis. It is acceptable to be more precise and calculate on a daily basis.

Deferred inflows of resources generally should be adjusted by the same amount as any change resulting from the remeasurement of the lease receivable as discussed in C: Other Contractual Elements; Lease Modifications.

## **<u>Step 9: Lessor's underlying asset:</u>**

A lessor should not derecognize the asset underlying the lease. A lessor should continue to apply other applicable guidance to the underlying asset, including depreciation and impairment. However, if the lease contract requires the lessee to return the asset in its original or enhanced condition, a lessor should not depreciate the asset during the lease term. (GASB 87, paragraph 55)

**Step 10: Current financial resources measurement focus:**

In financial statements prepared using the current financial resources measurement focus, a lessor should recognize a lease receivable and deferred inflows of resources to account for a lease. A lessor should measure the deferred inflows of resources at the initial value of the lease receivable (see Step 6), plus the amount of any payments received at or before the commencement of the lease term that relate to future periods (for example, the final month's rent). A lessor subsequently should recognize the deferred inflows of resources as inflows of resources (revenue), if available, in a systematic and rational manner over the term of the lease. (GASB 87, paragraph 56)

## 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 incentive payments to be provided after the commencement of the lease term should be accounted for by lessors as reductions of lease payments for the periods in which the incentive payments will be provided. Those payments should be measured by lessors consistently with the lessor's lease receivable (see Steps 6 & 7). 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:** Lessors 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 lessor 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 the 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)

**Lease Terminations**: The lessor 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 lessor should account for the partial or full lease termination by reducing the carrying values of the lease receivable and related deferred inflows of resources, 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 carrying value of the underlying asset should be derecognized and included in the calculation of any resulting gain or loss. (GASB 87, paragraph 79)

**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 lessor should continue to apply the general lessor guidance. (GASB 87, paragraph 80)

- Exception: If your department entered into a sublease with another department, do not report the sublease.

**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)