

Forever Leases

BY MICHELE MARK LEVINE

In November 2020 the Governmental Accounting Standards Board (GASB) issued an exposure draft titled *Implementation Guidance Update—2021*. The exposure draft (ED) has 28 new questions and answers—21 of which are on the topic of leases—and four amendments to previously issued questions and answers. The ED also includes five new questions and answers on fiduciary activities and one each on derivative instruments, grant revenue recognition, capitalization policies, revenue from fines, major fund determination, and intra-entity asset transfers. Finally, the ED proposes to supersede four previously issued questions and answers related to intangible assets.

LEASES

The lease guidance being proposed in the ED would be the third round of implementation guidance related to GASB Statement 87, *Leases*, bringing the total number of questions and answers issued on the topic to 120. When issuing GASB Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, GASB provided a one-year deferral for most authoritative guidance previously due to

become effective for periods beginning after June 15, 2018, but prudently instead provided a longer, 18-month postponement for implementation of GASB 87. This has given both governments and GASB additional time to recognize and address the myriad questions and concerns that have been arising as governments work toward implementation of a standard that is proving to be surprisingly challenging.

Below is a summary of the leases-related questions and answers proposed for the 2021 update of GASB's Comprehensive Implementation Guide. If the ED were to be issued as final guidance in its present form, these proposed clarifications would be made authoritative (Level B) generally accepted accounting principles (GAAP).

Questions 4.7 and 4.8 relate to the definition of a lease.

Agreements between departments within a government are not leases, as a lease is required to convey control of the right to use *another entity's* underlying asset. In a contract where all payments are variable payments based on future events, and thus no lease liability and lease asset (for a lessee) or a lease receivable and deferred inflow

of resources (for a lessor) would be reported, the payments would nonetheless be considered when determining if the contract is, in fact, a lease (i.e., it is an exchange or exchange-like transaction).

Question 4.9 relates to provisions that allow for a lease to be terminated due to a violation of lease terms.

A provision that allows for a lease to be terminated due to a violation of the lease terms would not be considered a termination option for the purpose of determining the lease term.

Question 4.10 relates to lease term reassessment.

When an advance notice period is required for either party to exercise rights that both have to terminate a lease without the consent of the other party, that notice period is the noncancellable period of the lease, and any remaining period under the agreement is a cancellable period. At each year end, the reporting government must reassess the lease term. Thus, if no notice of termination has been given by either party, and other factors

remain unchanged, the reassessed noncancellable period would again be the advance notice period.

Question 4.11 relates to noncontiguous periods of a lease term in the determination of whether a lease is a short-term lease.

The maximum possible term of a lease, for the purpose of determining if a contract is a short-term lease, includes only the periods of time during which control of the underlying asset is conveyed to the lessee, rather than the total length of time during which the agreement is in effect. Specifically, if a government enters into a contract covering three calendar years in which the right to use an underlying asset is limited to three months each year, the maximum term is considered to be nine months (three years x three months per year), which does not exceed one year; thus, the lease is a short-term lease.

Question 4.12 relates to accounting for financed purchases.

A financed purchase, which is excluded from the definition of a lease, should be accounted for as the acquisition of the underlying capital asset and the incurrence of a long-term debt by the government that is purchasing the asset, and as a disposal (including recognition of a gain or a loss, as appropriate) and a long-term receivable by the selling government.

Question 4.13, 4.14 and 4.17 relate to lease interest expense and revenue.

If a lessee government pays the full amount due under a multiyear lease contract upon inception of the lease term, no interest expense is recognized by the lessee. Also, accrued lease interest payable is a separate liability from the lease liability. For governmental lessors that account for leases in enterprise funds or that are stand-alone business-type entities, interest revenue should be accounted for as nonoperating revenue, even those funds or entities for which leasing property to others is the principal ongoing operation.

Question 4.15 relates to the reimbursement of lessor's costs by lessee.

When a lease contract specifies that payments be made to reimburse the lessor for a pro rata share of lessor's taxes and insurance, those are considered nonlease components of the contract and should be recognized by the lessee as expenses/expenditures in the periods for which they are incurred.

Question 4.16 relates to government lessors use of property managers to lease assets to third parties.

A property manager that enters into contracts to rent space in a government-owned building to third parties is acting on behalf of the owner government, and thus the lease contracts should be accounted for as being between the government and the third parties.

Questions 4.18 and 4.19 relate to remeasurement of leases when payments made to a governmental lessor vary based on actual sales in the leased retail space.

Remeasurement is not required when, on an annual basis, the amount of a variable payment for the next year is determined based on events that occurred during the year then ended. Two examples are used in the ED in which a minimum guaranteed payment is specified for the first year of a contract for retail space in which a government is the lessor. In one example, each subsequent year's guaranteed minimum payment is a fixed percentage of sales in the preceding

year, and are thus variable payments. In the other example, each prior year's guaranteed minimum payment is the greater of either 105 percent of the prior year's payment or a fixed percent of the sales in the prior year, resulting in the 105 percent of the prior year's guaranteed minimum payment being fixed in substance. In both cases, at the conclusion of each year the amount of the subsequent year's payment becomes known. However, in neither case is the government required to remeasure the lease receivable because a contingency is resolved only for the subsequent year, not for the remainder of the lease term.¹

Question 4.20 relates to accounting by a lessor for advance payments of first and final months' lease payments and for security deposits.

Prior to commencement of the lease term, a lessor government would account for advance payments received from a lessee of first and final month's lease payments and for security deposits as liabilities. Upon commencement of the lease term, the lessor should recognize the first month's payment as lease revenue, the last month's rent should be accounted for as a prepayment in the calculation of the deferred inflow of resources related to the lease, and the security deposit should continue to be carried as a liability until refunded or applied to amounts due under the lease. Here are example journal entries (under the economic resources measurement focus and accrual basis of accounting):

| Upon advance receipt of rental payments and security deposit: | Debit | Credit |
|---|-------|--------|
| Cash | XX | |
| Lease advance (liability) | | XX |
| Upon inception of the lease term: | | |
| Lease advance (excluding last month's rent) | XX | |
| Lease revenue (1st month's rent) | | XX |
| Security deposit payable | | XX |

Questions 4.21 through 4.23 relate to lease incentives.

Sometimes a new lessor agrees to assume a lessee’s remaining obligations to an “old” (third-party) lessor under a preexisting lease contact, as an incentive for the lessee to enter into a new lease agreement with the new lessor. The appropriate accounting (under the economic resources measurement focus and accrual basis of accounting) would be as follows:

GASB prudently provided a longer postponement for implementation of GASB 87, which has given both governments and GASB additional time to address the myriad questions and concerns that have been arising.

| Upon termination of old lease: | Debit | Credit |
|--|-------|--------|
| Loss on termination of old lease | XX | |
| Old lease asset | | XX |
| Upon payment-in-full being made to old lessor by new lessor: | | |
| Old lease liability | XX | |
| New lease advance (liability) | | XX |
| Upon inception of new lease: | | |
| New lease advance | XX | |
| New lease asset | | XX |

Additionally, a “rent holiday” covering the last period of the term of a lease (as opposed to one covering an initial period, which is more common) is an example of an incentive that is to be provided after the inception of the lease term. Such incentives should be accounted for by excluding lease payments that would otherwise be due during the rent holiday from the calculation of the present value of future lease payments when determining the lease liability (lessee) or lease receivable (lessor). Finally, improvements required in a lease contract to be made by a lessor, and that are not reimbursed by a lessee, should not be accounted for as incentives – or in any way factor into the measurement of the lessor’s receivable—but should be accounted for as improvements to the lessor’s underlying capital asset.

Questions 4.24 through 4.26 relate to lease modifications and terminations.

Lease modifications should be accounted for in the period in which the lease terms are modified, rather than waiting until the period in which the modification takes effect, if later. Reassessment of a lease discount rate is required when a lease modification. And, in the case of a lease modification, a lessee should measure the lease liability the same way it would be measured in an initial lease liability measurement, rather than as a remeasurement. The guidance on remeasurement is applicable when changes arise from options existing within, and reassessments based on, the original lease contract.

Question 4.27 relates to transition guidance.

A lease that has one year or less remaining in its term as of the end of the first fiscal year in which a government implements GASB 87, is a short-term lease.

NEW PROPOSALS ON TOPICS OTHER THAN LEASES

Here is a summary of the new questions and answers in the ED related to topics other than leases, and the clarifications they would make to GAAP if promulgated as part of a final Implementation Guide Update by GASB.

Question 4.1 relates to derivative instruments.

A contract that does not capture market changes, such as changes in overall interest rates and credit worthiness (referred to as “nonparticipating”), should not be accounted for as derivative instruments, even if they otherwise meet the definition of derivative instruments. The example in the question specifically relates to a contract for forward delivery bonds that fixes the price and interest rate of the bonds to be issued in a future period.

Questions 4.2 through 4.6 relate to Fiduciary Activities.

Three questions (4.2, 4.3, and 4.6) relate to employee benefit plans (including pension, OPEB, and other employee benefit plans). Specifically, they say that determination of whether an employee benefit plan should be accounted for as a (1) pension plan, (2) other postemployment plan, or (3) other employee benefit plan is not affected by which Internal Revenue Code section under which the plan is organized. Additionally, an employer

government does not recognize an outflow of resources when it transfers assets of a non-trusted defined contribution pension plan to a third-party administrator that will hold the assets until they are distributed to employees (retirees); instead, those assets should continue to be reported as assets of the appropriate governmental and/or proprietary fund(s). Finally, by selecting the set of investment options available to participants in an employee benefit plan, an employer government is not directing the use, exchange, or employment of the assets, and thus does not have control of the assets.

Two questions (4.4 and 4.5) indicate when proceeds of shared revenues should be reported as fiduciary activities. In two examples, a county government provides birth and death certificates to the public from the state's records database for a fee, a portion of which is retained by the county and a portion of which is remitted to the state. When the amount of the fee is set by the state, the county should report its share of the revenue in the appropriate governmental or proprietary fund and the share held prior to remittance to the state in a fiduciary fund. When the amount of the fee is set by the county, with state law requiring that 20 percent of the amount collected be remitted to the state, the entire amount collected should be reported in the appropriate governmental or proprietary fund. The distinction is that when the county sets the fee, the fee is own-source revenue to the county, which cannot be a fiduciary activity.

Question 4.28 relates to contractual agreements for nonexchange transactions.

When nonexchange transactions require entering into one or more contracts, such as grant agreements, acceptance of terms and conditions, or project worksheets, the execution of those agreements is required to

occur during or prior to the period of revenue recognition. This is true even in the cases where recipients may be reimbursed for allowable costs that are incurred prior to execution.

AMENDED Q&A

Question 5.1 proposes to clarify that governments should establish capitalization policies that require capitalization of assets whose individual acquisition costs are less than the threshold for an individual asset, if those assets in the aggregate are significant. The prior answer to 7.9.8 of Implementation Guide 2015-1 could have been interpreted to make capitalization under these circumstances optional.

Question 5.2 proposes to clarify that even for governments that use revenue from fines to support many programs, and even in cases where fines are one of the largest sources of revenue governmental activities, fines should be reported as charges for services of the function or programs from which the fine revenues are derived. The prior answer to 7.33.5 of Implementation Guide 2015-1 may not have appeared to be applicable when fines are one of the largest sources of revenue supporting governmental activities.

Question 5.3 proposes to clarify that a major governmental or proprietary fund may be reported as such only for a single year, if it passes the quantitative test to be a major fund for only that one year. Governments do have the option, however, of choosing to report a fund as major even if it does not pass that test, and may want to do so for the sake of consistency. The prior answer to 7.55.3 of Implementation Guide 2015-1 could have been interpreted to apply only to capital projects funds.


Question 5.4 proposes to insert a reference to GASB Statement 92, *Omnibus 2020*, in a question clarifying the proper reporting of a transfer of an asset by a primary government (PG)

to a pension plan that is a component unit of a PG, in the plan's separately issued financial statements.

The ED also proposes to supersede Questions Z.51.4 through Z.51.7 of Implementation Guide 2015-1. These were mistakenly retained when GASB 72, *Fair Value Measurement and Application*, superseded the provisions of GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, that had exempted "assets that are acquired or created primarily for the purpose of directly obtaining income or profit" from treatment as intangible assets. GASB 72 instead defined investments in such a way as to incorporate most such intangible assets.

PROPOSED EFFECTIVE DATES

The effective dates proposed for the questions in the ED vary by topic, as follows:

- The proposed new questions and answers that deal with derivative instruments, fiduciary activities and nonexchange transactions, as well as all amended questions and answers (4.1 – 4.6, 4.28, and 5.1 – 5.4) and the supersession of Z.51.4 – Z.51.7 of Implementation Guide 2015-1, would be effective for reporting periods beginning after June 15, 2022.
- All of the proposed questions and answers that deal with leases (4.7 – 4.26), except for the question regarding transition (4.27), would be effective for fiscal years beginning after June 15, 2022, and all reporting periods thereafter. The transition guidance question and answer (4.27) would be effective for fiscal years beginning after June 15, 2021 (the effective date of GASB 87). 

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¹ Additionally, the ED points out that "an event that results in a change in the amount of future payments that are fixed in substance is not the same as an event that results in future payments becoming fixed."