



Learning Lots about Leases

BY MICHELE MARK LEVINE

GFOA recently presented a series of two webinars on the topic of the Governmental Accounting Standards Board Statement No. 87, *Leases* (GASB 87). The second of the two sessions was built primarily around detailed examples of some of the more complex aspects of lease accounting. The process of developing the examples, which illustrate the calculations and journal entries that would be used to account for a variety of leases and circumstances, highlighted a few key points that are worth discussing. These examples can be found on GFOA's website at gfoa.org/GFR/leases.

Lessor versus lessee accounting in governmental funds.

While much of the accounting by lessors parallels accounting by lessees, there is a fundamental way in which their accounting differs. When making lease calculations, the lease liability reported

by a lessee and the lease receivable reported by a lessor are both measured using the present value of future lease payments, and the lessee's lease asset and the lessor's deferred inflow of resources from the lease are both measured using parallel calculations, as well. However, for a lessee, the lease liability is a long-term debt obligation¹ and the lease asset is a capital asset, both of which are excluded from governmental funds and are included in governmental activities in government-wide financial statements only as a result of adjustments made specifically for that purpose. For a lessor, on the other hand, a lease receivable is a financial resource that is reported in a governmental fund, as is the related deferred inflow of resources.

Remeasurement resulting from extension and cancellation options vs. purchase options. To initially calculate the term of a lease, each

party must individually evaluate the likelihood that one party will exercise an extension option or a cancellation option,² with periods subject to extension options being factored into the term if they are deemed reasonably certain to be exercised and periods subject to termination options included if they are deemed reasonably certain of not being exercised. Subsequently, *only the actual exercise or lapsing of* an extension or termination option contrary to the originally determined reasonable certainty—not changes in the assessed *likelihood* of exercise—would result in a change to the lease term,³ thereby requiring the lessee to remeasure the lease liability and make a corresponding change to the lease asset. If the *likelihood* of a purchase option being exercised changes from or to being reasonably certain, however, the lessee would remeasure the lease liability and make a corresponding

change to the lease asset without waiting for the actual exercise or lapsing of the option to occur.⁴

Lessor versus lessee accounting for contracts with multiple lease components. When a contract contains multiple components, a lessee needs to distinguish and allocate payments among lease and non-lease components, and also—within the lease components—between right-to-use assets in different major asset classes, in order to properly report the individual right-to-use capital assets. A lessor, however, need only allocate payments between lease and non-lease components. For example, assume a contract provides for a lessee to use building space and equipment belonging to a lessor, and for the lessor to maintain the equipment. The lessee will need to allocate payments between a service contract—for the equipment maintenance—and between a building lease asset and an equipment lease asset, while the lessor will need to allocate only between a service contract and a (single) lease component.

Lessor vs. lessee accounting for lease modifications resulting from lessor's bond refinancing from which lessee benefits. When a lessor refinances debt related to a lease and shares the economic benefits (generally, lower interest rates) of refinancing with the lessee, the amount of the change in the present value of future lease payments is recorded by the lessor as a change in the lease receivable and as a new deferred inflow of resources or deferred outflow of resources (separate from, and in addition to, the original deferred inflow established at the lease inception). While the original deferred inflow is amortized as lease revenue, the new deferred flow is then amortized⁵ as a *gain* or a *loss*. For the lessee, however, the change in the present value of future lease payments is recorded as a change in the lease liability and a deferred inflow of resources or deferred outflow of resources (separate from the lease asset), which is then amortized as a

reduction of or an addition to interest expense. The interest expense adjustment makes sense, because the change in payments does not represent any change in the value of the lease asset but reflects the “pass through,” from the lessor to the lessee, of the interest rate changes resulting from the refinancing.

For a lessee, the lease liability is a long-term debt obligation and the lease asset is a capital asset, both of which are excluded from governmental funds.

Effective interest rate imputation for sale-leaseback transactions. In a sale-leaseback transaction, the value of the underlying asset is established as part of the sale transaction.⁶ Thus, where the lease transaction transfers the right to use the entire asset to the seller/lessee, it would generally make sense to impute the lease discount rate by setting the present value of the future lease payments equal to the established value of the underlying asset, as permitted in GASB 87.⁷ In cases where the sale-leaseback is deemed to have off-market terms (the sale price is higher than the fair value of the underlying asset), the substance of the transaction may be that, in addition to the sale-leaseback, a loan is being made by the buyer/lessor to the seller/lessee. In that case, the interest rate would need to be inferred for the loan portion of the transaction in order to properly and fully amortize the loan principal.

Reporting intra-entity leases between a primary government and its blended component unit.

Interfund leases would generally fall into the category of interfund services provided and used, meaning that the revenue and expenses (expenditures, in the case of governmental funds) should not be eliminated in order to avoid overstating costs of one function while understating those of another. In the case of an intra-entity lease between a primary government and a blended component unit, *all* of the effects of the lease *other than revenue and expenditure/expense equal to the actual lease payments made during the period* should be eliminated from the respective funds of the primary government and blended component unit *before* the fund financial statements of the combined entity are prepared.

Stay tuned for more on leases in this space and on GFOA's website as governments continue the process of implementing this major new standard. 📺

Michele Mark Levine is director of GFOA's Technical Services Center. Michele would like to gratefully acknowledge the tremendous assistance of others in developing the examples associated with this article (available on GFOA's website at gfoa.org/GFR/leases). Assistance was provided Deborah Beams; Todd Buikema, GFOA's Technical Services Assistant Director for Publications; and Peg Hartnett, GFOA's Technical Services Assistant Director for Training.

¹ Leases are not considered debt for the purposes of disclosures required by GASB Statement No. 88, *Certain Disclosures Related to Debt, Including Direct Borrowings and Direct Placements*.

² If both parties' consent is needed to extend, the period covered is excluded from the lease term. If both parties have the option to terminate, the period covered is also excluded from the lease term.

³ GASB 87, paragraph 15.a.

⁴ GASB 87, paragraph 25.c. and GASB Implementation Guide No. 2019-3, *Leases* question 4.34.

⁵ Amortized over the remaining life of the old or new debt, whichever is shorter (GASB 87, paragraph 76.a.).

⁶ GASB 87, paragraph 84.

⁷ GASB 87, paragraphs 23 and 47.