

Leases Examples

Overview – For Illustration Only

What follows are examples of lease transactions and events based on GASB Statement 87, Leases, as amended and expanded on by subsequent GASB pronouncements through June 30, 2020. The assumptions, methods of estimation, and other factors regarding the recognition and measurement of various aspects of the transactions are not necessarily the only acceptable or the best options.

GFOA urges all governments to carefully consider all aspects of their own actual or contemplated transactions, apply their best professional judgement to their unique facts and circumstances to determine the most appropriate application of generally accepted accounting principles (GAAP), and consult with their independent auditors and other appropriate parties (including, as applicable, state government oversight authorities and grantors) before making any accounting and financial reporting decisions. These are especially important with regard to transactions and events that are new to the government and/or that are the subject of newly-implemented GAAP.

Example 1: Building Lease with Variable Payments Determined by an Index and Variable Payments Depending on Future Events

The County of Example (the County) leases an unused building (the Building) from the Example Independent School District (the District) to for administrative offices. The District and the County are not in the same reporting entity.

The lease is for a noncancelable 10-year term, 7/1/2012 to 6/30/2022. The County has the (unilateral) option to extend the lease term for an additional 10-year term, and must notify the District of its decision no later than 6/30/20 in order to exercise this option.

Base rent of \$120,000/year, adjusted as discussed below, is payable on July 1st each year, with the first and final years' base rent paid on 7/1/2012.

In year 2 (paid 7/1/2013), rent is adjusted by the amount of the change (from the prior year) in the most recently published annual Commercial Property Price Index (CPPI) for the region. The CPPI is published by a respected economic analysis organization in the first quarter of each year for the prior calendar year (CY). In all subsequent years, the rent will be adjusted by any increase or decrease in CPPI, however it will never decrease below the amount of the original base rent.

In addition to the indexed base rent, the County will pay the District an allocated portion of the District's annual premium for specified types and levels of insurance coverage that the district maintains on all its buildings and grounds. The allocation will be based on the proportion of the district's total insured building area represented by the Building. The allocated insurance costs

from FYE 2013 (payment made 7/1/2012) is \$17,000, and the District and the County estimate that is the lowest it will be for any year of the lease term.

The lease does not specify an interest rate, and the District has not calculated the periodic payments it is charging the County based on a specific interest rate. The District is not able to estimate the rate implicit in the lease contract, does not know the County's incremental borrowing rate and is not able to identify similar instruments for which there are published market rates. Therefore the District uses its own estimated incremental borrowing rate of 2.5% as of 7/1/2012, the inception of the lease term, as the discount rate in calculating the PV of the future lease payments it will receive. The County uses its own estimated incremental borrowing rate as of the same date as the discount rate when calculating the PV of future payments it will make, which is 2.0%.

The County considers the following in initially determining how likely it is to exercise its extension option:

- The leased space is used by the County's computer center and as offices for its finance department "back-office" operations.
- The County had assessed other options prior to entering into this lease contract and found this to be the most economical; it has no reason to believe that the real estate market will change over the noncancelable term in a way that would change the relative costs of other options.
- The County estimates that the cost of relocating at the end of the noncancelable period would be \$100,000.

Based on these considerations, the County determines that it is reasonably certain to exercise its extension option, and it shares this information with the District. The District also concludes it is reasonably certain that the County will exercise its extension option.

The District's carrying value of the building is \$1,000,000, and at the time the lease is entered into, the District estimates the building's remaining useful life to be 30 years. The district uses straight-line depreciation.

Both the District and the County have 6/30 FYEs, account for the lease in their general funds, and use a full-year convention for amortization of all capital assets and deferred outflow/inflows of resources from leases.

The actual changes in CPPIs for CYs 2012 and 2013 are +5% and +1%, respectively.

The actual insurance charges for FYEs 2014 and 2015 are \$17,500 and \$18,000, respectively.

Example 2: Change in Lease Term and Remeasurement of Lease Asset, Lease Liability, Lease Receivable and Deferred Inflow of Resources Pertaining to a Lease

Assume the same facts as in Example 1, with the follow new developments.

During FYE 2020, the County decided to move all of its computing into the cloud, and to have virtually all remaining finance department staff work remotely. The County expects to be able to accomplish the necessary transition before June 30, 2022, and as a result, the County does not exercise its extension option before it expires on June 30, 2020.

Additional information:

- The cumulative/net change in the CPPI through 12/31/2018 was +40%, which the County knows will have significant effect on lease asset and lease liability
- The County's incremental borrowing rate as of June 30, 2020 has fallen to 1.75%
- There is no change in the District's incremental borrowing rate (or to the rate it charges the County)
- The actual changes in CPPIs for CYs 2020 and 2021 are -15% and +5%, respectively

Example 3: Contract with Multiple Lease and Non-lease Components

Example County Community College (College) enters into a contract with the Example Independent School District (District) to use 10 classrooms (each of approximately 1,200 square feet) and necessary related space¹ in a District school building on weekday evenings from 5pm until 10pm, when demand from working adults for classes is highest. In addition to providing the space, complete with furniture and fixtures, the District will clean and maintain the classrooms, bathrooms, entryways, and hallways, and will provide HVAC, power, high-speed internet access, security staff and other ancillary services to the College. The 10-year noncancelable term, with no extension or termination options, begins on July 1, 20X1. The College will pay the District \$500,000 annually, due on July 1st of each year.

The District determined the payment amount based on its estimated incremental operating costs and a contribution toward its general operating overhead; it expects that the arrangement will not result in any significant additional wear and tear on its facility and furnishings.

The college has been unable to identify comparable space and used furnishings to rent, but has determined that using the proportion of costs it would incur to rent, configure, furnish and operate class B office space for this purpose is a reasonable approach to allocating contract costs among lease and non-lease components, and between the rights to use the space and

¹ Entryways, hallways, bathrooms, etc.

furniture & fixtures components of the lease. Based on research, the College determines that the total annual cost would be \$715,000, and those costs would be comprised of:

- \$500,500 per year costs to rent and configure comparable space (70% of \$715,000 total applied to \$500,000 annual payment would be \$350,000)
- \$71,500 per year to rent furniture (10% of \$715,000 total applied to \$500,000 annual payment would be \$50,000)
- \$143,000 for cleaning and security services (20% of \$715,000 total applied to \$500,000 annual payment would be \$100,000)

The District charges 3% interest on the lease component, and each party shares all of the above information with the other.

The District's building and furniture and fixtures both have remaining useful lives estimated to extend beyond the lease term, and the annual depreciation on each is \$800,000 and \$64,600, respectively.

The District and the College both have 6/30 FYEs, account for the lease in their general funds, and use a full-year convention for amortization of all capital assets and deferred outflow/inflows of resources from leases.

Example 4: Refunding by Lessor, Benefiting Lessee

The County of Example (the County) enters into a contract with Sample City (the City) for the purpose of constructing new office space for both governments. Under the contract, the City agreed to lease half of the building from the County for City offices for a period of 40 years. The City's rent is equal to 50% of the County's annual debt service on the bonds issued to finance – or refinance - the building construction (including 50% of all underwriter's fees and any premium or discount, amortized on a straight line basis over the life of the bonds), beginning upon bond issuance (i.e., 40 annual payments would be made 7/1/20A1 – 7/1/20E0, while occupancy will be from 7/1/20A3 – 6/30/20E3). The use of rent receipts by the County is restricted by the contract and by the bond indenture to the payment of debt service on the bonds issued to construct the building.

On July 1, 20A0, the County issues \$68,010,400 par value of general obligation bonds that mature over a 40-year period and that pay interest and principal annually in the amount of \$5,175,600 on July 1st at an annual rate of 7.125% to finance the construction of an office building in the City. The bonds sold with an original issuance discount (OID) of \$1,000,000, the underwriter's discount was \$500,000 and other issuance costs were \$510,400. The building takes 3 years to construct and costs \$66,000,000. It has an expected useful life of 50 years. The bonds are callable after 10 years at a 2 point premium above par.

At the time the bonds become callable, market interest rates have fallen dramatically and the County makes plans to refund the original bond issue. The refunding issue is sized to cover the balance of the outstanding original bond issue remaining after the 7/1/20B0 debt service payment, the call premium, another \$1,000,000 underwriter's discount and \$681,640 of additional costs of issuance. The refunding bonds are issued on 7/1/20B0, mature over a 33-year period and that pay interest and principal annually in the amount of \$4,175,600 on July 1st at an annual rate of 5.055%

The County uses a capital projects fund to hold resources for the purpose of, and to make payments for, major capital projects. The County uses a debt service fund to hold resources for the purpose of, and to make payments for, principal and interest on its outstanding G.O. debt; because the lease payments from the City are restricted to paying debt service, the County also accounts for the sub-lease in this debt service fund. The City uses its general fund to account for leases. Both the County and the City use a full year convention for depreciation and amortization.

Example 5: Sale-Leaseback Transaction with Off-Market Pricing

The State of Example (the State) incorporates a public benefit corporation, the Example State Capital Corporation (the Corporation), for the purpose of entering into sale-leaseback transactions with local governments within the state. The corporation is properly reported as a blended component unit of the State.

On January 1, 2021, the Corporation issues \$110,000,000 par value of bonds at 102, paying a \$5,500,000 bond underwriter's discount and \$1,000,000 of other issuance costs. The bonds pay interest, at 6%, and principal in the total amount of \$6,978,872 on January 1st each year for 50 years.

Also on January 1, 2021, the Corporation closes on a contract to purchase Sample City's (the City's) historic capital building (the Building) for \$90,000,000, and enters into a related contract to lease the Building back to the City for a fixed period of 50 years for an annual cost of \$7,000,000, with the first payment due on December 31, 2021. The Corporation's bonds are backed by a pledge of the lease revenue. The interest rate charged by the Corporation can be imputed based on known value of the Building.

At the date of the sale, the City's net carrying (book) value for the Building (and all components thereof) is \$12,000,000 (\$50,000,000 cost and \$38,000,000 accumulated depreciation) and its assessed fair value is \$72,000,000. Under the terms of the contract, the City is required to return the Building in the same or better condition at the end of the lease.

The City is not a Component Unit of the State. Both the City and the Corporation have fiscal years ending on June 30th, follow governmental accounting, and use a half-year convention for depreciating and amortizing capital assets, deferred inflows of resources and deferred outflows

of resources, as appropriate. Both the City and the Corporation account for the lease in their general funds. The Corporation records revenue based on a 30-day availability period.

Example 6: Lease and Sub-Lease/Intra-Entity Sub-lease

Sample City (the City) enters into two lease contracts with terms beginning on January 1, 2021. The first is to lease a five-story office building from Private Developer, Inc. (the Developer) and the second is to sub-lease one of the five floors of the same building to Sample Economic Development Corporation (the Corporation), a governmental entity.

The lease contract with the Developer specifies that Sample City will pay \$50,000 per month for a fixed 5 year term. As the lease contract does not specify an interest rate, the City uses its estimated incremental annual borrowing rate of 6% (0.5% per month). The Sub-lease contract with the Corporation specifies the same fixed 5 year term, the same 6% interest rate, and a monthly rental payment of \$10,000. Both contracts require that the first months' rent be paid on January 1, 2021, with monthly payments required on the first day of each subsequent month. The City's contract with the Developer requires an additional \$25,000 damage deposit be paid on January 1, 2021, which will be refunded, less the cost to repair any damage, after the space has been vacated. The City does not expect to lose any portion of the deposit.

Both the City and the Corporation follow governmental accounting, account for the leases in their general funds, have fiscal years ending on June 30th, and follow a half-year convention for depreciation and amortization.

For simplicity, assume that the City and Corporation began FYE 2021 with only the following balances, and had no other activity for the period:

	City	Corp
Cash	1,000,000	100,000
Fund balance/net position	1,000,000	100,000

Display fund and government-wide financial statements under 3 scenarios:

- A. The Corporation and the City are not in same reporting entity
- B. The Corporation is a discretely presented CU of the City
- C. The Corporation is blended CU of the City, and its only governmental fund reported as a major special revenue fund

Example 7: Lease asset impairment

A town leases a small store-front space to serve as a visitors' center, but the building in which the space is located is damaged in a flood. Assume that at the time of the flood the lessee's remaining lease liability is \$15,000 and its unamortized lease asset value is \$10,000. Assume that those amounts are equal to the lessor's remaining lease receivable and deferred inflow of resources, respectively. What entries would be required for each party under each of the following scenarios?

	Scenario A	Scenario B	Scenario C
% of the remaining lease term during which a portion of the space will be unavailable to the Town	50%	100%	100%
% of the space that will be unavailable during that time	20%	80%	80%
Decline in the lease liability (PV of reductions to future rent payments agreed to by the landlord as a result of the impairment)	No change	\$7,500	\$10,000