



February 21, 2014

**Memorandum**

To: Members of the Board  
*M.R. Valentine*

From: Monica R. Valentine, Assistant Director

Through: *Wendy M. Payne*, Executive Director

Subject: Leases Project – **Tab A**<sup>1</sup>

**MEETING OBJECTIVE**

To discuss with the GASB their tentative decisions on the Lease project that could provide insights into the development of comprehensive federal lease accounting standards. The Boards will also discuss at a high-level their thoughts on the proposed FASB/IASB lessor model.

**BRIEFING MATERIAL**

- Staff Memo
- Attachment I
  - GASB Tentative Board Decisions through February 2014 Teleconference
- Attachment II
  - A - FASAB Review of GASB Tentative Decisions on Lease Project – Summary of Member Results
  - B - GASB Staff Paper September 2013 Issue 1, Paper 2
- Attachment III
  - A - GASB Staff Paper – Foundation of Lessor Model
  - B - FASAB Federal Lessor examples

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

## Background

At the December 2013 meeting the Board briefly discussed the GASB tentative decisions on their leases project to date with the GASB Practice Fellow leading their leases project.

Staff discussed with the Board the responses to the ten-question federal lease activities questionnaire staff sent to several federal entities. The purpose of the questionnaire was to gather data on the leasing activities and practices of federal entities, the input will assist FASAB develop revised lease standards for the federal government. Staff noted that the responses highlight the need for comprehensive lease accounting standards for the federal government, especially now since FASB is actively working to modify its current lease standards. The Board noted the following based on the results of the lease questionnaire:

- Focus in on the federal aspects of lease accounting
- Highlight possible issues related to intra-governmental leasing activities
- Identify the user needs as it relates to federal lease activities
- Identify the cost-benefit of having different lease accounting recognition and lease budget scoring.

An additional staff paper provided to the Board included a discussion on whether the Board should look to SFFAC 5's definition of an asset and liability to determine if a federal entity's **right to use** a leased asset and the **obligation to make lease payments** are assets and liabilities of the entity.

All of the members agreed to explore the single-model approach as opposed to the dual-model approach. The Board also highlighted the following as it relates to the lease project:

- It would be helpful to know the annual interest expense for federal entities' leases
- The single model is preferred because it will be easier for agencies to have just one class of leases
- The single-model approach is a practical expedient and is conceptually sound.
- Articulation is necessary between the lessee and the lessor reporting because of significant intra-governmental leasing
- Identifying any possible exceptions
- Implementation issues should be addressed
- The current two year useful life criteria used to determine capitalization of general property, plant & equipment should be considered as a possibility for lease balance sheet recognition.
- Assess the cost-benefit of having two approaches to leasing analysis – one for budget purposes and the other for accounting purposes
- The Board should be looking at providing decision useful information.

In January staff asked the Board to provide their input in a survey format on the tentative decisions made by the GASB on their lease project to date. A summary of the survey results along with staff's analysis and recommendations of the survey are included in Attachment II of this memo.

Based on the results of the survey, staff has identified the following topics for further discussion during the joint meeting with GASB.

**Board Discussion Questions**

1. **Should the presence of fiscal funding clauses, termination for cause clauses, and other cancellation clauses specific to the federal environment cause a lease to be considered cancellable?** *[decision 5]*
2. **Is the FASAB definition of “probable” adequate in the context of assessing the likelihood of a renewal option being exercised?** *[decision 5]*
3. **What additional factors would trigger a reassessment of the lease term?** *[decision 6]*
4. **The following questions relate to allowing for an exception for short term leases** *[decision 13]:*
  - a. **What is the objective of having a short-term exception? Is it to provide cost relief to entities by allowing more simplified accounting (i.e., not required to recognize assets and liabilities) for those leases that meet the definition of short-term?**
  - b. **What is the definition of short-term?**
  - c. **Should the definition of short-term create possible disincentives to the lessee/lessor to intentionally structure leases to meet the short-term definition?**
  - d. **Should the short-term exception be based on a certain period of time (e.g., 12 months or 24 months, etc.)**
  - e. **What is the maximum possible term? Does the maximum possible term include options to extend the lease term?**
  - f. **Should the presence of purchase option disqualify the short-term exception?**
  - g. **Should leases that transfer ownership be included in the scope of the lease standard? If so, should leases that transfer ownership qualify for the short-term exception?**
5. **Which discount rate should be used to calculate the liability?** *[decision 16]*
6. **When should the discount rate be reassessed?** *[decision 25]*
7. **Is there a need to clarify or simplify the process of allocating multiple components of the lease?** *[decision 29]*

**MEMBER FEEDBACK**

If you require additional information or wish to suggest another alternative not considered by staff, please contact staff as soon as possible. In most cases, staff would be able to respond to your request for information and prepare to discuss your suggestions with the Board, as needed, in advance of the meeting. If you have any questions or comments prior to the meeting, please contact me by telephone at 202-512-7362 or by e-mail at [valentinem@fasab.gov](mailto:valentinem@fasab.gov) with a cc to [paynew@fasab.gov](mailto:paynew@fasab.gov).



## MEMORANDUM

**Issue 6, Paper 1**  
**March 2014 Meeting**

**To:** Board Members and David Bean  
**From:** Deborah Beams, Randy Finden, Jialan Su, Ken Schermann, Christopher Teats, Cody Domasky  
**c:** GASB Staff, Task Force Members, and Meeting Observers  
**Date:** February 18, 2014  
**Re:** Leases Project: Joint Meeting with FASAB Cover Memo

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The Board's March meeting will include a joint discussion with the Federal Accounting Standards Advisory Board (FASAB) regarding leases. Each board is engaged in a project that could potentially change accounting requirements for leases, and the boards have agreed to collaborate in certain respects on these projects. Attachment A to this cover memo is the material developed by the FASAB staff for discussion at the joint meeting regarding tentative decisions made to date (this attachment will be distributed to the Board as soon as it is received from the FASAB). Attachment B is the Board's tentative decisions through the February 2014 teleconference. Paper 2 is the material developed by the GASB staff regarding the foundation of a lessor accounting model.

## **Tentative Board Decisions through February 2014 Teleconference**

The Board tentatively agreed to propose that:

- The definition of a lease be revised to be “a contract that conveys the right to use an asset (the underlying asset) for a period of time in an exchange or exchange-like transaction”
- The scope of the Leases guidance continue to include contracts not identified as leases but that meet the definition of a lease
- The scope of the Leases guidance continue to exclude:
  - Contracts for services that do not transfer the right to use assets from one contracting party to the other
  - Leases to explore for or use of minerals, oil, natural gas, and similar nonregenerative resources
  - Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights
  - Service concession arrangements
- The scope of the Leases guidance also exclude biological assets, including timber
- A single accounting model be developed, potentially with exceptions for certain circumstances
- The lease term include:
  - The noncancellable period
  - Periods covered by renewal options (or exclude periods covered by termination options) that are probable of being exercised based on an assessment of qualitative factors
  - Periods covered by fiscal funding and cancellation clauses if the possibility of cancellation is remote (If the possibility of cancellation is more than remote, the period should be treated as any other termination option when determining the lease term.)
- Cancellable periods be excluded from the lease term
- The lease term be reevaluated when there is a change in relevant factors that would result in a change in judgment as to the lessee’s likelihood to exercise or terminate the lease, or when the lessee actually exercises or terminates the lease opposite of what was previously expected
- The relevant factors used in the initial assessment of the lease term also be the factors that result in a reassessment
- The underlying assumption that leases are financings be the foundation for the governmental leasing model
- The right to use the underlying asset be recognized as an asset by the lessee
- The general approach to measuring lease assets and liabilities be to measure the liabilities first and base the assets on that amount

- The general measurement approach for a lease liability be based on the present value of future payments
- The obligation to make lease payments be recognized as a liability by the lessee
  - The obligation to return the underlying asset at the end of the lease not be recognized as a liability by the lessee
- A practicality exception be made for short-term leases
  - A short-term lease be defined as a lease that, at the beginning of the lease, has maximum possible term under the contract, including any options to extend, of 12 months or less
  - The maximum possible term for a cancellable lease be defined as any noncancellable period, including any notice periods
  - The definition of a short-term lease not depend on the presence of a purchase option
  - A short-term exception be an accounting requirement for all leases that qualify
  - Lessees not be required to recognize assets or liabilities associated with the right to use the underlying asset for short-term leases
  - Lease payments be recognized as expenses/expenditures based on the terms of the contract
  - Lease payments for short-term leases rent holiday or rent reduction provisions be recognized as expenses in accrual accounting financial statements based on the terms of the contract
- There not be a practicality exception made for leases of noncore assets
- The initial measurement of a lease liability for a lessee include:
  - Fixed payments to be made over the lease term
  - Variable payments based on an index or rate, using the rate in effect at that date
  - Variable payments that are in-substance fixed
  - Residual value guarantees probable of being required based on an assessment of qualitative factors
  - Purchase options probable of being exercised based on an assessment of qualitative factors
  - Termination penalties if based on the determination of the lease term, the termination option is probable of being exercised
- Lease payments that are dependent on a lessee's performance or usage of an underlying asset not be included in the measurement of the lease liability
- Payments not included in the liability measurement be recognized as expense in the accrual accounting-based flows statement in the period in which the obligation for those payments is incurred
- Lease liability payments be discounted using the rate the lessor charges the lessee and if that rate cannot be readily determined, the lessee's incremental borrowing rate should be used
- The initial measurement of a lease asset for a lessee include:

- The value of the initial lease liability
- Any prepayments (amounts paid for the lease prior to measuring the lease liability)
- Initial direct costs if they are ancillary charges to place the leased asset into use
- Lease incentives received be reductions in the cost of lease assets
- Initial direct costs be expensed if they are costs other than ancillary charges to place the leased asset into use
- A lessee remeasure a lease liability by calculating the amortization of the discount on the lease liability and reducing the lease liability by the actual lease payment amount less the amortization of the discount
- Lease assets be amortized using a systematic and rational basis over the shorter of the useful life of the underlying asset or the lease term
- The lessee amortize the right-of-use asset as if the lessee owns the underlying asset, using the lessee's depreciation policy, if the lease transfers ownership or if by assessing qualitative factors a purchase option is determined to be probable of being exercised. In those situations, if the underlying asset is a non-depreciable asset such as land, the lessee should not amortize the right-of-use asset
- The lessee classify the amortization of the lease asset as amortization expense and the amortization of the discount on the lease liability as interest expense in the flows statement
- The right-of-use asset in a lease is an intangible asset that should be accounted for in accordance with existing authoritative guidance for capital assets
  - The relationship between the underlying asset and the lease asset could mean that indicators of impairment present with respect to the underlying asset may result in a change in the manner or duration of use of the lease asset
  - A change in the manner or duration of use of the lease asset may indicate impairment of that asset
  - In circumstances in which an asset underlying a lease is damaged and requires restoration or replacement, the time period during which the underlying asset is not usable generally is the relevant factor in assessing whether the impairment test has been met.
  - An impaired lease asset first would be adjusted by any change in the corresponding lease liability, with any remaining adjustment recognized as the impairment loss
- A reassessment of a lease liability be required in any of the following situations:
  - A change in the likelihood (probable to not probable or vice versa) of a purchase option being exercised based on an assessment of qualitative factors

- Either a change in the amounts expected to be payable under a residual value guarantee or when there is a change in the likelihood (probable to not probable or vice versa) that a payment will be required based on an assessment of qualitative factors
- Result of a change in an index or a rate used to determine lease payments during the reporting period may be significant
- A reassessment of the discount rate be required in any of the following situations:
  - Lease term is changed
  - A change in the likelihood (probable to not probable or vice versa) that a purchase option will be exercised based on an assessment of qualitative factors
  - Result of a change in the reference rate used to determine a variable lease payment may be significant
- Initial selection of a discount rate also be the approach for selection of a discount rate in the event of a reassessment
- Adjustments arising from remeasurements of lease liabilities also adjust the right-of-use asset by the same amount. The exception is adjustments due to a change in the rate upon which a variable lease payment is based, which are recognized as revenue or expense in the current period
- If the adjustment to the lease liability is greater than the carrying value of the lease asset, the difference be recognized in the flows statement
- Contracts separated into lease and nonlease components or multiple lease components, subject to a practicality exception related to measurement
- Allocate consideration to multiple components, lessees:
  - First use prices in the contract for individual components, if available, and if those prices are reasonable based on other observable standalone prices
  - If individual prices are not available or not reasonable, allocate consideration based on relative observable standalone prices, if those prices are available for all components of the contract
  - If observable standalone prices are not available for all components,
    - Allocate the standalone price to any components for which there are such prices and then
    - Consider any remaining components to be a single unit of account and assign the remaining consideration to that unit
- Accounting for multiple lease components that are considered as one unit for accounting purposes be based on the primary component
- The guidance in Statement 13 relating to the accounting treatment for operating leases with scheduled rent increases be superseded

1. The definition of a lease be revised to be “a contract that conveys the right to use an asset (the underlying asset) for a period of time in an exchange or exchange-like transaction.”

**Staff note:** At the FASAB August meeting staff recommended to the Board that the FASAB definition of lease use the term “agreement” as opposed to “contract” because using “contract” could narrow the scope of the lease standards and not capture all leasing transactions involving federal entities. The Board agreed to defer the questions of terminology until later in the deliberations.

<u>Member agreement to GASB decision 1:</u>				
1	2	3	4	5
Strongly Agree<=====		Uncertain<=====	Strongly Disagree	
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 2 members				
3 ==> 1 member				
5 ==> 2 members				
<b><u>Member comments on GASB decision 1:</u></b>				
- Okay with using “agreement”				
- Agree, but should either reference “contract” or an agreement subject to documented terms. This seems to be a reasonable common reference point with GASB.				
- The term contract is narrow; however, in a positive sense, it helps to identify and make more certain the decision. “Agreement” could be so subjective that we lose consistency in what should be reported. If the agency reviews all of the criteria for recording as a lease and they are clear, a contract may be the appropriate answer. Then it is more enforceable.				
- I also like agreement rather than contract since I doubt agencies sign contracts with each other.				
- Agree with deferral of decision, but tentatively support the definition except that I prefer “agreement”. Would consider discussing the basis of GASB’s decision with GASB in our joint meeting. Would we want to continue alignment with PP&E (i.e., minimum lease term of two years or more)? If so, would this be in the definition (similar to PP&E) or as part of recognition? Also need to consider OMB budgetary lease accounting.				

**Staff Analysis:** A majority of the Board agrees with the overall definition and appears to support the use of “contract” instead of “agreement” in the definition of a lease.

*FASB’s Proposed Accounting Standards Update (Revised) Leases (Topic 842) [FASB Proposed Lease Standard]*, defines **contract** as an agreement between two or more parties that creates enforceable rights and obligations.

In the federal environment the definitions of “lease” and “contract” will need to be applicable to federal leases with non-federal entities, as well as General Services Administration’s (GSA) occupancy agreements (OA) with federal entities and other interagency lease agreements (IAA). According to our counsel, a contract includes an offer, acceptance, consideration, and intent to be legally binding. In most instances GSA OA and other IAA include all of the elements of a contract. If the standards are clear regarding the elements of a contract and that substance rather than form governs then either term should accomplish the same result.

**Staff Recommendations:** The use of the term “contract” would be appropriate in the definition of lease as it relates to leasing activities of federal entities.

2. The scope of the Leases guidance continue to include contracts not identified as leases but that meet the definition of a lease.

**Staff note:** *At the FASAB August meeting the Board agreed with staff’s recommendation to include in the scope of the lease project agreements that reflect the substance of a lease even if they are not called a lease.*

3. The scope of the Leases guidance continue to exclude:
  - Contracts for services that do not transfer the right to use assets from one contracting party to the other
  - Leases to explore for or use of minerals, oil, natural gas, and similar nonregenerative resources, also exclude biological assets, including timber
  - Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights
  - Service concession arrangements

**Staff note:** *At the FASAB August meeting the Board agreed with staff’s recommendation that the scope of FASAB lease standards exclude three of the above four bulleted topics, with the exception being internal use software and other intangible assets that will be further researched.*

**Member comments on GASB decision 2 & 3:**

- Agree with scope definition and exceptions. Need to research internal use software provisions for application to licensing exception noted by GASB.

- With respect to service concession arrangements, (1) are we using the broader 3P terminology, and (2) are we planning to include recognition in the 3P standard or rely on the leasing standard?

**Staff Analysis:** GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, includes within its scope licensed computer software. “Examples of intangible assets include easements, water rights, timber rights, patents, trademarks, and computer software. Intangible assets can be purchased or licensed (which includes acquisition through an installment contract), acquired through nonexchange transactions, or internally generated.” [GASB 51, par 1]

FASAB SFFAS 10, *Accounting for Internal Use Software*, paragraphs 66 – 67 and Technical Release 5, *Implementation Guidance on Statement of Federal Financial Accounting Standards 10: Accounting for Internal Use Software*, paragraphs 12 – 14 state that software licenses should follow the lease standards outlined in SFFAS 5 & 6.

**Staff Recommendations:** Since the current standards state that software licenses should be included in the lease standards, software licenses will need to be include in the scope of this project or specifically addressed in a separate project. Staff recommends including software licenses within the scope of this project.

4. A single accounting model be developed, potentially with exceptions for certain circumstances.

**Staff note:** At the FASAB December meeting the Board agreed to explore the single-model approach as opposed to the dual-model approach.

**Member comments on GASB decision 4:**

- Helps to at least clarify the Budgetary/Financial accounting divide re: this specific issue. GSA currently works to ensure that all leases score as operating leases, because only the amount needed to cover the minimum rent payment must be scored against GSA’s fiscal year BA.

**Staff Analysis:** Currently the budget scoring for leases is specified in OMB *Circular No. A-11: Preparation, Submission, and Execution of the Budget – Appendix B – Budgetary Treatment of Lease-Purchases and Leases of Capital Assets - 2013 (A-11)* and is based on the current accounting for leases (i.e., SFAS 13). A-11 outlines six criteria in which all must be met in order for a lease to be considered an operating lease for budget scoring purposes. If the criteria are not met, the lease will be considered to be a capital lease or a lease-purchase. The criteria are:

1. Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease term;
2. The lease does not contain a bargain-price purchase option;
3. The lease term does not exceed 75 percent of the estimated economic life of the asset;
4. The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the beginning of the lease term;

5. The asset is a general purpose asset rather than being for a special purpose of the Government and is not built to the unique specification of the Government as lessee; and
6. There is a private sector market for the asset.

The current accounting for leases states that if one or more of the four criteria are met the lease will be considered a capital lease. With the exception of the two additional criteria in A-11, the budget scoring for leases and the accounting classification for leases are the same.

The question for the Board to consider is, is it necessary to have alignment between the budgetary scoring and the financial accounting for lease?

**Staff Recommendation:** Because there is no specific reason that the budgetary scoring and the financial accounting should be aligned, we recommend that the Board not consider alignment between the two. Differences between the two bases are understandable given the different objectives of financial and budgetary accounting.

5. The lease term include:
- The noncancellable period (cancellable periods be excluded from the lease term)
  - Periods covered by renewal options (or exclude periods covered by termination options) that are probable of being exercised based on an assessment of qualitative factors
  - Periods covered by fiscal funding and cancellation clauses if the possibility of cancellation is remote (If the possibility of cancellation is more than remote, the period should be treated as any other termination option when determining the lease term.)

**Staff note:** *From the federal perspective, the lease term determination may need additional Board discussion because of the intra-governmental leasing arrangements (through occupancy agreements) between GSA and many federal entities.*

Member agreement to GASB decision 5, excluding any guidance needed for intra-governmental leasing:

1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				

**Summary of Results:**

1 ==> 4 members  
 2 ==> 3 members  
 5 ==> 1 member

**Member comments on GASB decision 5:**

- We should address intra-governmental leasing in our statement.
- Note that the GASB definition of “probable” differs from that of the FASAB. I prefer the FASAB definition.
- I am OK with GASB decisions, except we need to have a better understanding of the budget rules on long term leases and how they can be provided for.
- Agree with staff note.
- This issue needing additional discussion, notwithstanding, these seem to be reasonable caveats to establishing the leasing term. Application of the “fiscal funding and cancellation clause seems particularly noteworthy given recent budget issues.
- Need to consider parity between lessor/lessee accounting for intra-governmental leases

FASB Proposed Lease Standard defines **lease term** as:

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with both of the following:

- Periods covered by an option to extend the **lease** if the lessee has a significant economic incentive to exercise that option
- Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on what should be included in the lease term. However, a few related issues will need to be addressed.

- Clearly define cancellable and noncancellable periods, taking into consideration GSA OA
- Because renewal options are not included in GSA OA, additional consideration of renewals may be necessary.
- The significance of fiscal funding clauses, termination for cause clauses, and other cancellation clauses specifically in the federal environment.

As one member pointed out, GASB’s definition of probable is “the future event or events are likely to occur” and FASAB’s definition of probable is “that which can reasonably be expected or believed to be more likely than not on the basis of available evidence or logic but which is neither certain nor proven.” Therefore, the second bullet in GASB’s tentative definition of the lease term related to renewal options will need to be assessed against FASAB’s definition of probable. GASB and FASAB’s definitions of “remote” are the same.

**Staff Recommendation:** Staff believes that using the GASB’s tentative definition of “lease term” as a starting point for the federal definition is appropriate. However, including further discussions on the above points would also be added.

6. The lease term be reevaluated when there is a change in relevant factors that would result in a change in judgment as to the lessee’s likelihood to exercise or terminate the lease, or when the lessee actually exercises or terminates the lease opposite of what was previously expected.

Member agreement to GASB decision 6:

1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				

**Summary of Results:**

1 ==> 4 members  
 2 ==> 1 member  
 3 ==> 1 member  
 4 ==> 2 members

**Member comments on GASB decision 6:**

- I agree where the likelihood is very strong.
- We should make a determination at the start and live with it. If the lease terminates, then we would not need to unwind the lease and its accounting at that time.
- Depends on the factors selected. I don’t want agencies put into a position where they have to reevaluate all leases annually.
- By definition a change should occur when we have an accounting event and know the dollar value of an impact. In this case a change in likelihood may not actually be an accounting event.
- Need to consider parity between lessor/lessee accounting for intragovernmental leases

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the reevaluation of the lease term given the change in relevant factors. However, based on the comments received from members, staff suggests that the Board consider the GASB staff paper pages 25 – 31 of the *GASB September 2013 Issue 1, Paper 2* staff paper (topic heading “Changes or Amendments to Lease Terms”) which is included as Attachment II-B. The GASB staff paper references the lease term sections of the *FASB Proposed Lease Standard* and provides as an analysis of the topic from the GASB perspective.

The *FASB Proposed Lease Standard* notes that all relevant contract-based, asset-based, market-based, and equity-based factors should be considered. The proposal also gives several examples of factors to consider.

**Staff Recommendation:** Staff recommends that the Board begin with the factors suggested in the *FASB Proposed Lease Standard* and make the necessary revisions to those factors as applicable to the federal sector, also other relevant factors specific in the federal environment may be added.

7. The relevant factors used in the initial assessment of the lease term also be the factors that result in a reassessment.

<u>Member agreement to GASB decision 7:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 2 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 7:</u></b>				
- For consistency.				
- May or may not. Impossible to pre determine.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the factors that result in a reassessment of the lease term.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position.

8. The underlying assumption that leases are financings be the foundation for the governmental leasing model.

<u>Member agreement to GASB decision 8:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 3 members				
3 ==> 2 members				
<b><u>Member comments on GASB decision 8:</u></b>				
- I suspect this assumption must be made in order to perform the accounting. However, I submit that there are probably leasings entered into not as financings, but for other reasons, e. g., the lessor has a property which he does not want to sell; the lessee does not have the time to purchase or construct a desired asset, a leasable property is more desirable, etc.				
- I don't completely agree and would want to discuss because sometimes it is like a service and has nothing to do with financing. An example being a lease to perform a specific service during the term of the service.				
- I'm simply not clear on the tangible value of this assertion				
- Need to consider the nature of federal leases, including intragovernmental				

**Staff Analysis:** A majority of the members agree with GASB's tentative decision that the underlying assumption that leases are financings be the foundation for the federal leasing model. This assumption will be used to as the primary basis for the development of a single-model approach to federal lease accounting. This assumption does not assert with certainty that all federal leases are entered into solely to obtain financing arrangements, but it does assert that significant number of federal leasing transactions are based on the financing premise. The financing premise is that lease arrangements compensate the lessor for both the consumption over time of the leased asset and the lessor's capital investment in the asset (return of capital and return on capital). From the lessee's perspective, this implies there is an interest expense incurred as a cost of financing. As we continue to work with our task force and develop the standard this assumption may change. If the Board believes there is not enough research to support this assumption, this decision could be deferred.

**Staff Recommendation:** Staff recommends that the assumption that leases are financings be the foundation for the federal leasing model.

9. The right to use the underlying asset be recognized as an asset by the lessee.

<u>Member agreement to GASB decision 9:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 2 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 9:</u></b>				
- Depends on other decisions, including intra-governmental				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decision of lessee recognition of the right to use the underlying asset as an asset.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position.

10. The general approach to measuring lease assets and liabilities be to measure the liabilities first and base the assets on that amount.

<u>Member agreement to GASB decision 10:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 4 members				
2 ==> 3 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 10:</u></b>				
- I think that the liability amount is a good foundation, including additional costs of bringing the asset into service, but can't help thinking that there are other factors that should be considered / accounted for - - e.g., how did the lessor account for the asset upon purchase?				
- In some circumstances, especially in those involving leases that are essentially purchases, it may be easier to measure the value of the asset than the liability. Any statement issued should make it clear that the value of the liability and asset should be based on the one which is the more readily determinable.				
- I am in basic agreement with this notion, but I want a better understanding of the impact of this position on the net position of the entity after the assets and liabilities are recorded.				
- Depends on other decisions, including intra-governmental				

**Staff Analysis:** A majority of the members agree with GASB's tentative decision of a general approach to measuring lease assets and liabilities by measuring the liabilities first and base the assets on that amount.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position and consider other factors including practical application.

11. The general measurement approach for a lease liability be based on the present value of future payments.

<u>Member agreement to GASB decision 11:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 3 members				
<b><u>Member comments on GASB decision 11:</u></b>				
- I would want to discuss how to account for renewals and other payments tied to options in the lease.				
- Depends on other decisions, including intra-governmental				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decision of a general measurement approach for a lease liability being based on the present value of future payments.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position.

12. The obligation to make lease payments be recognized as a liability by the lessee.
- The obligation to return the underlying asset at the end of the lease not be recognized as a liability by the lessee.

<u>Member agreement to GASB decision 12:</u>				
1	2	3	4	5
Strongly Agree<=====		Uncertain<=====	Strongly Disagree	
<b><u>Summary of Results:</u></b>				
1 ==> 7 members				
2 ==> 1 member				
<b><u>Member comments on GASB decision 12:</u></b>				
- Agree – the lease payments, themselves, should be structured to account for the return and/or residual value of the underlying asset.				
- Are there conditions in which the lessee makes modifications to the asset and is not financially in a position to return the asset in an acceptable condition at the end of the lease term? Is a liability created then?				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decision that the obligation to make lease payments be recognized as a liability by the lessee and the obligation to return the underlying asset at the end of the lease not be recognized as a liability by the lessee. The amounts to be included in the initial measurement of the liability, including residual value guarantees, are specified in *decision 14*.

**Staff Recommendation:** Staff recommends that the Board act on the premise that a liability for the lease payments be recognized and further address the specifics of lease recognition and measurement.

13. A practicality exception be made for short-term leases

- A short-term lease be defined as a lease that, at the beginning of the lease, has maximum possible term under the contract, including any options to extend, of 12 months or less
- The maximum possible term for a cancellable lease be defined as any noncancellable period, including any notice periods The definition of a short-term lease not depend on the presence of a purchase option
- A short-term exception be an accounting requirement for all leases that qualify *[rather than the option to choose]*
- Lessees not be required to recognize assets or liabilities associated with the right to use the underlying asset for short-term leases
- Lease payments be recognized as expenses/expenditures based on the terms of the contract

**Staff note:** *From the federal perspective the short-term exception may need additional discussion because of the criteria of a 2 year useful life for PP&E capitalization (SFFAS 6). The Board may want to consider this 2 year criteria with the short-term exception criteria.*

<u>Member agreement to GASB decision 13:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 3 members				
3 ==> 1 member				
4 ==> 1 member				
<b><u>Member comments on GASB decision 13:</u></b>				
- I agree with the short term criteria. I need discussion on an asset leased for 2 years when the asset has a five year life as compared to a lease of 2 years and the asset has a 25 year life.				
- I agree in general with the <= 12 months exception re: short-term leases and understand that an additional exception may be required for a certain class of PP&E. However, those exceptions should be as limited and as narrowly defined as possible.				
- Align with SFFAS 6.				
- I agree with the staff's note on using a longer period than one year as one year seems too short.				

**Staff Analysis:** A majority of the members agree with GASB's tentative decisions on an exception for short-term leases.

**Staff Recommendation:** Staff recommends that the Board further address the specifics of a short-term exception, including the following questions.

- What is the objective of having a short-term exception? Is it to provide cost relief to entities by allowing more simplified accounting (i.e., not required to recognize assets and liabilities) for those leases that meet the definition of short-term?
- What is the definition of short-term?
- Should the definition of short-term create possible disincentives to the lessee/lessor to intentionally structure leases to meet the short-term definition?
- Should the short-term exception be based on a certain period of time (e.g., 12 months or 24 months, etc.)
- What is the maximum possible term? Does the maximum possible term include options to extend the lease term?
- Should the presence of purchase option disqualify the short-term exception?
- Should leases that transfer ownership be included in the scope of the lease standard? If so, should leases that transfer ownership qualify for the short-term exception?

14. The initial measurement of a lease liability for a lessee include:
- Fixed payments to be made over the lease term
  - Variable payments based on an index or rate, using the rate in effect at that date
  - Variable payments that are in-substance fixed
  - Residual value guarantees probable of being required based on an assessment of qualitative factors
  - Purchase options probable of being exercised based on an assessment of qualitative factors
  - Termination penalties if based on the determination of the lease term, the termination option is probable of being exercised

Member agreement to GASB decision 14:

1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				

**Summary of Results:**

1 ==> 3 members  
 2 ==> 3 members  
 3 ==> 2 member

**Member comments on GASB decision 14:**

- I need a better understanding of how purchase options and termination penalties are present valued.  
 - I want more discussion and research on this. I would like to see the results of applying this and what we would be missing.

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the measurement of a lease liability for a lessee.

**Staff Recommendation:** Staff recommends that the Board begin with GASB’s measurement and further address the specifics of lease recognition and measurement.

15. Lease payments that are dependent on a lessee’s performance or usage of an underlying asset not be included in the measurement of the lease liability.

<u>Member agreement to GASB decision 15:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 3 members				
3 ==> 2 members				
<b><u>Member comments on GASB decision 15:</u></b>				
- In certain circumstances, such as those in which a minimum payment must be made (e.g. rent is based on copies used, but there is a minimum number that must be paid for regardless of usage) then the minimum payment should be included in the lease liability.				
- I want more discussion as this would still be a liability and cost of using the asset.				
- I need more clarification as to the intent/meaning of this provision. Are they referring to some sort of “conditional lease”? Why would one enter into a lease arrangement if they were uncertain as to whether they were going to actually occupy/use the asset?				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that lease payments that are dependent on a lessee’s performance or usage of an underlying asset not be included in the measurement of the lease liability. The amounts to be included in the initial measurement of the liability, including variable payments that are in-substance fixed (minimum guarantee), are specified in *decision 14*.

**Staff Recommendation:** Staff recommends that the Board begin with GASB’s tentative decision and further address the specifics of lease recognition and measurement.

16. Lease liability payments be discounted using the rate the lessor charges the lessee (i.e., the implicit rate in the lease) and if that rate cannot be readily determined, the lessee's incremental borrowing rate should be used.

<u>Member agreement to GASB decision 16:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 2 members				
3 ==> 2 members				
4 ==> 1 member				
<b><u>Member comments on GASB decision 16:</u></b>				
- How does the lessee know the rate the lessor is charging?				
- As most agencies don't borrow money, should this be more specific to Federal borrowing rate?				
- Presumably, for the Federal Government, the rate would be set pursuant to OMB guidance, not unlike the rates prescribed for credit reform?				
- Would we consider the treasury rate if lessor's implicit rate cannot be determined? Also, need to consider cost/benefit for intra-governmental leases?				

**Staff Analysis:** A majority of the members agree with GASB's tentative decisions that lease liability payments be discounted using the rate the lessor charges the lessee and if that rate cannot be readily determined, the lessee's incremental borrowing rate should be used.

The following excerpt is from the current capital lease standards.

***Excerpts from SFFAS 5: Accounting for Liabilities of the Federal Government***  
**Capital Leases**

44. The amount to be recorded by the lessee as a liability under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the liability should be the fair value. If the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated.
45. The discount rate to be used in determining the present value of the minimum lease payments ordinarily would be the **lessee's incremental borrowing rate** unless (1) it is practicable for the lessee to learn **the implicit rate computed by the lessor** and (2) the

implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both these conditions are met, the lessee shall use the implicit rate. The lessee's incremental borrowing rate shall be the Treasury borrowing rate for securities of similar maturity to the term of the lease.

46. During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability.

**Staff Recommendation:** Staff recommends that the Board further address the specifics of selecting a discount rate and consider the meaning of "the lessee's incremental borrowing rate" in the federal context.

17. The initial measurement of a lease asset for a lessee include:
- The value of the initial lease liability
  - Any prepayments (amounts paid for the lease prior to measuring the lease liability)
  - Initial direct costs if they are ancillary charges to place the leased asset into use or expensed if they are other costs

<u>Member agreement to GASB decision 17:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 3 members				
3 ==> 1 member				
4 ==> 1 member				
<b><u>Member comments on GASB decision 17:</u></b>				
- I agree with the components, but feel some additional clarification is justified. This is likely semantics, but seems that the above should be a little more specific re: how prepayments are treated with respect to the initial lease liability. Is the initial lease liability calculated and then reduced for the amount of prepayments? Are prepayments calculated first, and then an initial lease liability calculated – factoring in the prepayments?				
- I believe that several types of indirect costs should “capitalized” and included as part of the lease asset rather than expensed.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the initial measurement of a lease asset for a lessee.

**Staff Recommendation:** Staff recommends that the Board further address the specifics of lease asset recognition and measurement including how the capitalized costs would compare to SFFAS 6 capitalization requirements and the treatment of prepayments.

18. Lease incentives received be reductions in the cost of lease assets.

<u>Member agreement to GASB decision 18:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 2 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 18:</u></b>				
- Presumably considering the likelihood that the incentives will be acted upon.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that Lease incentives received be reductions in the cost of lease assets.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt the GASB position.

19. Initial direct costs be expensed if they are costs other than ancillary charges to place the leased asset into use.

<u>Member agreement to GASB decision 19:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 4 members				
2 ==> 2 members				
4 ==> 2 members				
<b><u>Member comments on GASB decision 19:</u></b>				
- If we are going to capitalize the lease as an asset, we should capitalize any lease initial cost that would have capitalized if it was an asset purchased.				
- I believe that many types of indirect costs should be capitalized as part of the lease asset.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that initial direct costs be expensed if they are costs other than ancillary charges to place the leased asset into use.

**Staff Recommendation:** Staff recommends that the Board further explore the SFFAS 6 guidance for capitalization and determine whether or not that guidance is applicable to leased assets.

20. A lessee remeasures a lease liability by calculating the amortization of the discount on the lease liability and reducing the lease liability by the actual lease payment amount less the amortization of the discount.

<u>Member agreement to GASB decision 20:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 2 members				
3 ==> 2 members				
4 ==> 1 member				
<b><u>Member comments on GASB decision 20:</u></b>				
- I do not understand this.				
- Shouldn't the reduction be by the delta between the new and old lease payment, factoring in the amortization of the discount?				
- Uncertain with intra-governmental leases				

**Staff Analysis:** A majority of the members agree with GASB's tentative decisions that a lessee remeasures a lease liability by calculating the amortization of the discount on the lease liability and reducing the lease liability by the actual lease payment amount less the amortization of the discount.

*See attached illustrations from GASB staff paper of the lessee initial and subsequent measurement of the right of use asset and lease liability.*

**Staff Recommendation:** Staff recommends that the Board further discuss liability remeasurement to clarify how the interest component of periodic payments ('discount amortization') and the remaining liability balance are calculated over time.

21. Lease assets be amortized using a systematic and rational basis over the shorter of the useful life of the underlying asset or the lease term.

<u>Member agreement to GASB decision 21:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 2 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 21:</u></b>				
- The straight line method of depreciation coupled with a compound interest method of amortizing the liability causes the total lease expense to be front-loaded – i.e., much higher in early years than in later years. While I have no objection to giving leases the option to using the straight-line method I think we should encourage them to use a method (which is conceptually sound) in which the depreciation charge is equal to the amortization of the liability.				
- Uncertain re:intra-governmental leases				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that Lease assets be amortized using a systematic and rational basis over the shorter of the useful life of the underlying asset or the lease term.

*See attached illustrations from GASB staff paper of the lessee initial and subsequent measurement of the right of use asset and lease liability*

**Staff Recommendation:** Staff recommends that the Board tentatively adopt the GASB decision and discuss the suggestion regarding encouraging use of alternatives to straight line depreciation.

22. The lessee amortize the right-of-use asset as if the lessee owns the underlying asset, using the lessee’s depreciation policy, if the lease transfers ownership or if by assessing qualitative factors a purchase option is determined to be probable of being exercised. In those situations, if the underlying asset is a non-depreciable asset such as land, the lessee should not amortize the right-of-use asset.

<u>Member agreement to GASB decision 22:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 4 members				
3 ==> 1 member				
<b><u>Member comments on GASB decision 22:</u></b>				
- It seems that point 22 should be addressed before point 21. Point 22 defines if amortization is to be done. Point 21 defines how amortization should be done.				
- Agree but would want to explore to ensure we are not missing something.				
- The straight line method of depreciation coupled with a compound interest method of amortizing the liability causes the total lease expense to be front-loaded – i.e., much higher in early years than in later years. While I have no objection to giving leases the option to using the straight-line method I think we should encourage them to use a method (which is conceptually sound) is which the depreciation charge is equal to the amortization of the liability.				
- Uncertain re: intra-governmental leases				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions with the lessee’s amortization of the right-of-use asset, but with some degree of uncertainty.

**Staff Recommendation:** Staff recommends that the Board further address this matter.

23. The lessee classify the amortization of the lease asset as amortization expense and the amortization of the discount on the lease liability as interest expense in the flows statement.

**Staff note:** *The statement of net cost does not provide this disaggregation. Members may consider the need for this either on the face of the statement or the disclosures.*

<u>Member agreement to GASB decision 23:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
3 ==> 2 members				
<b><u>Member comments on GASB decision 23:</u></b>				
- I would suggest providing the disaggregation in disclosures.				
- See staff note.				
- Agree with no requirement to disaggregate unless material.				
- Uncertain re:intra-governmental leases				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that the lessee classify the amortization of the lease asset as amortization expense and the amortization of the discount on the lease liability as interest expense in the flows statement.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt the GASB position and further address presentation of the interest expense.

24. A reassessment of a lease liability in any of the following situations:
- A change in the likelihood (probable to not probable or vice versa) of a purchase option being exercised based on an assessment of qualitative factors
  - Either a change in the amounts expected to be payable under a residual value guarantee or when there is a change in the likelihood (probable to not probable or vice versa) that a payment will be required based on an assessment of qualitative factors
  - Result of a change in an index or a rate used to determine lease payments during the reporting period may be significant

<u>Member agreement to GASB decision 24:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 4 members				
2 ==> 1 member				
3 ==> 2 members				
4 ==> 1 member				
<b><u>Member comments on GASB decision 24:</u></b>				
- Too much work?				
- Curious as to why a change in lease duration is not considered as a factor. At a minimum, should consider clarifying the third bullet to refer to situations other than refinancings to alter the periodic payments. How exactly do we measure likelihood?				
- I am more in favor of establishing the accounting in the beginning and not changing it until facts actually happen and not to update based on assumptions.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the reassessment of a lease liability.

**Staff Recommendation:** Staff recommends that the Board further address the specifics of reassessments.

25. A reassessment of the discount rate be required in any of the following situations:
- Lease term is changed
  - A change in the likelihood (probable to not probable or vice versa) that a purchase option will be exercised based on an assessment of qualitative factors
  - Result of a change in the reference rate used to determine a variable lease payment may be significant

<u>Member agreement to GASB decision 25:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
3 ==> 4 members				
4 ==> 1 member				
<b><u>Member comments on GASB decision 25:</u></b>				
- I don't understand how the first two factors above affect the discount rate.				
- Too much work?				
- How does federal credit reform come into this discussion? With annual assessments or redeterminations will federal leases have to be revalued annually with gain or losses treated as credit events?				

**Staff Analysis:** No consensus on GASB's tentative decisions on the reassessment of the discount rate.

**Staff Recommendation:** Staff recommends that the Board further address the discount rate and when the discount rate should be reassessed.

26. Initial selection of a discount rate also be the approach for selection of a discount rate in the event of a reassessment.

<u>Member agreement to GASB decision 26:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 5 members				
2 ==> 1 member				
3 ==> 1 member				
4 ==> 1 member				
<b><u>Member comments on GASB decision 26:</u></b>				
- This could use some clarification. Do they mean that the process to reassess should be consistent with the process to develop the initial assessment?				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the initial selection of a discount rate also be the approach for selection of a discount rate in the event of a reassessment.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position but deliberate the matter on the context of discount rate decisions as noted earlier.

27. Adjustments arising from remeasurements of lease liabilities also adjust the right-of-use asset. The exception is adjustments due to a change in the rate upon which a variable lease payment is based, which are recognized as revenue or expense in the current period.

<u>Member agreement to GASB decision 27:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 5 members				
<b><u>Member comments on GASB decision 27:</u></b>				
None				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on the adjustments arising from remeasurements of lease liabilities also adjust the right-of-use asset. The exception is adjustments due to a change in the rate upon which a variable lease payment is based, which are recognized as revenue or expense in the current period.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position.

28. Contracts separated into lease and nonlease components or multiple lease components, subject to a practicality exception related to measurement.

<u>Member agreement to GASB decision 28:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 4 members				
2 ==> 2 members				
3 ==> 2 members				
<b><u>Member comments on GASB decision 28:</u></b>				
- I foresee difficulties in implementation.				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions that contracts separated into lease and nonlease components or multiple lease components, subject to a practicality exception related to measurement.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position and consider guidance for identifying non-lease components.

29. Allocate consideration to multiple components, lessees:

- First use prices in the contract for individual components, if available, and if those prices are reasonable based on other observable standalone prices
- If individual prices are not available or not reasonable, allocate consideration based on relative observable standalone prices, if those prices are available for all components of the contract
- If observable standalone prices are not available for all components,
  - Allocate the standalone price to any components for which there are such prices and then
  - Consider any remaining components to be a single unit of account and assign the remaining consideration to that unit

Member agreement to GASB decision 29:

1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				

**Summary of Results:**

1 ==> 2 members  
 2 ==> 4 members  
 3 ==> 2 members

**Member comments on GASB decision 29:**

- Since this seems so complex, I need more understanding

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on lessee allocating consideration to multiple components.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position and discuss the reasons for members’ uncertainty. For example, do members see a need to clarify or simplify the allocation process?

30. Accounting for multiple lease components that are considered as one unit for accounting purposes be based on the primary component.

<u>Member agreement to GASB decision 30:</u>				
1	2	3	4	5
Strongly Agree<=====>Uncertain<=====>Strongly Disagree				
<b><u>Summary of Results:</u></b>				
1 ==> 3 members				
2 ==> 5 members				
<b><u>Member comments on GASB decision 30:</u></b>				
None				

**Staff Analysis:** A majority of the members agree with GASB’s tentative decisions on accounting for multiple lease components that are considered as one unit for accounting purposes be based on the primary component.

**Staff Recommendation:** Staff recommends that the Board tentatively adopt this position.

**Other Member comments:**

- Considering that so many leases in the Federal government are intra-governmental leases (GSA to others), one additional matter FASAB must address is accounting by lessors. Most agencies will be reporting a significant intra-governmental liability. If that amount does not match the amount reported as an intra-governmental receivable by GSA, the mismatch will be large enough to affect the opinion on the government-wide statements.
- I am generally in favor of following GASB, unless there is a Federal environment reason not to or not provide simplicity to follow.

## Appendix A

### Illustrations

#### Illustrations of Lessee Measurement and Reassessment of the Lease Term

##### Example 1—Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

##### Part 1—Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

**842-20-55-10** A lessee enters into a 10-year lease of an asset, with an option to extend for 5 years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. The lessee incurs initial direct costs of CU15,000.

**842-20-55-11** At the commencement date, the lessee concludes that it does not have a significant economic incentive to exercise the option to extend and therefore determines the lease term to be 10 years.

**842-20-55-12** The rate that the lessor charges the lessee is not readily determinable. The lessee's incremental borrowing rate is 5.87 percent, which reflects the fixed rate at which the lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease.

**842-20-55-13** At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining 9 payments of CU50,000, discounted at the rate of 5.87 percent, which is CU342,017.

**842-20-55-14** The lessee recognizes lease assets and liabilities as follows.

Right-of-use asset	CU407,017(CU342,017+CU 50,000+CU15,000)
Lease liability	CU342,017
Cash (lease payment for first year)	CU50,000
Cash (initial direct cost)	CU15,000

**842-20-55-15** During the first year of the lease, the lessee recognizes lease expenses as follows, depending on how the lease is classified.

### If the Lease Is Classified as a Type A Lease

**842-20-55-16** The lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, amortizes the right-of-use asset on a straight-line basis.

Interest expense	CU20,076(5.87% × CU342,017)	
Lease liability		CU20,076
Amortization expense	CU40,702(CU407,017 ÷ 10)	
Right-of-use asset		CU40,072

**842-20-55-17** At the end of the first year of the lease, the carrying amount of the lessee's right-of-use asset is CU366,315 (CU407,017 – CU40,702).

### If the Lease Is Classified as a Type B Lease

**842-20-55-18** The lessee determines the cost of the lease to be the sum of CU500,000 (sum of the lease payments for the lease term) and CU15,000 (initial direct costs incurred by the lessee). The annual lease expense to be recognized is therefore CU51,500 (CU515,000 ÷ 10 years).

Lease expense	CU1,500	
Lease liability		CU20,076(5.87% x CU342,017)
Right-of-use asset		CU31,424,(CU51,500 – CU20,076)

**842-20-55-19** At the end of the first year of the lease, the carrying amount of the lessee's right-of-use asset is CU375,593 (CU407,017 – CU31,424).

**842-20-55-20** At the end of the first year of the lease, the lessee's lease liability is CU362,093 (CU342,017 + CU20,076), regardless of how the lease is classified.

**842-20-55-21** At the beginning of the second year of the lease, the lessee makes the payment for that year, recognized as follows.

Lease liability	CU50,000	
Cash		CU50,000

## Appendix B - Illustration of Lease Liability Amortization Schedules

### Illustration B1

#### Lease Liability Amortization

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Total
Lease Payment - Decrease in Liability	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	<b>(500,000)</b>
Carrying Value of Lease Liability	342,017	312,093	280,413	246,874	211,365	173,772	133,973	91,837	47,228	(0)	
Discount Rate	5.87%	5.87%	5.87%	5.87%	5.87%	5.87%	5.87%	5.87%	5.87%	5.87%	
Interet Expense - Increase in Lease Liability	20,076	18,320	16,460	14,491	12,407	10,200	7,864	5,391	2,772	(0)	<b>107,983</b>
Carrying Value of Lease Liability	342,017	312,093	280,413	246,874	211,365	173,772	133,973	91,837	47,228	(0)	
<b>Liability at the end of the Year</b>	362,093	330,413	296,874	261,365	223,772	183,973	141,837	97,228	50,000	(0)	

## Appendix C - Illustration of Lease Asset Amortization Schedules

### Illustration C1

#### Lease Asset Amortization under Alternative 2

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10 *	Total
Annual Amortization of Lease Asset	(40,702)	(40,702)	(40,702)	(40,702)	(40,702)	(40,702)	(40,702)	(40,702)	(40,702)	(40,699)	<b>(407,017)</b>
Carrying Value of Lease Asset	407,017	366,315	325,613	284,911	244,209	203,507	162,805	122,103	81,401	40,699	
<b>Lease Asset at the end of the year</b>	366,315	325,613	284,911	244,209	203,507	162,805	122,103	81,401	40,699	0	
*	The different amount of amortization in Year 10 is due to rounding.										

### Illustration C2

#### Lease Asset Amortization under Alternative 3

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Total
<b>Annual Lease Expense</b>	51,500	51,500	51,500	51,500	51,500	51,500	51,500	51,500	51,500	51,500	<b>515,000</b>
Increase in Lease Liability	20,076	18,320	16,460	14,491	12,407	10,200	7,864	5,391	2,772	(0)	<b>107,983</b>
Amortization - Decrease in Lease asset	(31,424)	(33,180)	(35,040)	(37,009)	(39,093)	(41,300)	(43,636)	(46,109)	(48,728)	(51,500)	<b>(407,017)</b>
Carrying Value of Lease Asset	407,017	375,593	342,413	307,374	270,365	231,272	189,973	146,337	100,228	51,500	
<b>Lease Asset at the end of the year</b>	375,593	342,413	307,374	270,365	231,272	189,973	146,337	100,228	51,500	(0)	



## MEMORANDUM

**Issue 1, Paper 2**  
**September 2013 Meeting**

**To:** Board Members and David Bean  
**From:** Deborah Beams, Randy Finden, Jialan Su, Ken Schermann, Christopher Teats, Kathryn Walsh  
**c:** GASB Staff, Task Force Members, and Meeting Observers  
**Date:** September 4, 2013  
**Re:** Leases Project: Lease Terms

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### **I. INTRODUCTION**

The objective of this paper is to examine the definition of a lease term, or in other words, the duration of a lease. The lease term has an impact on the classification of leases under both the current Financial Accounting Standards Board (FASB) and GASB literature and the FASB's most recent Exposure Draft (ED). It also affects the measurement of lease-related assets and liabilities in certain circumstances under both current and proposed literature (which will be discussed at future meetings).

This paper will look at lease terms in the current literature and the most recent EDs issued by the FASB and the International Accounting Standards Board (IASB). This paper discusses the issues raised when defining a lease term and provides a basis for the Board to consider whether the definition of a lease term should be revised. The paper then looks at the effect that fiscal funding clauses could have on determining lease terms, and finally examines the circumstances in which the lease term should be reassessed.

### **II. DEFINITION OF LEASE TERM**

The term of a lease is important when accounting for leases. Lease terms are defined in the current literature of several of the major standard setters.

## **A. FASB, IASB, International Public Sector Accounting Standards Board (IPSASB) and Federal Accounting Standards Advisory Board (FASAB)**

The FASB defines a lease term in FASB Statement No. 13, *Accounting for Leases*, paragraph 5(f), as:

The fixed noncancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options (as defined in paragraph 5(e)), (ii) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph 5(o)) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (iv) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph 5(d)) is exercisable, and (v) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable" for purposes of this definition.

The IASB defines a lease term in International Accounting Standards (IAS) No. 17, *Leases*, paragraph 4, as:

[T]he non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

The IPSASB has issued International Public Sector Accounting Standards (IPSAS) No. 13, *Leases*. This standard, issued in 2001 and revised in 2006, was drawn primarily from current IASB lease guidance. IPSAS 13, paragraph 8, defines a lease term by using the exact wording of the IASB's definition, listed above.

While these definitions of a lease term are not identical to the FASB literature, which offers more detail on accounting for options, all use the same basic idea of what is the duration of the lease likely to be. For example, a bargain renewal option could be considered reasonably certain to be exercised because there is an incentive to do so.

FASAB standards address leasing transactions in Statement of Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of the Federal Government* and SFFAS 6, *Accounting for Property, Plant, and Equipment*, but do not include a definition of a lease term.

The FASB issued a revised ED, ASU Topic 842, *Leases*, in May 2013. The IASB also issued its revised ED on Leases at the same time. The proposed definition of a lease term would be consistent between both Boards. The FASB's ED, paragraph 842-10-25-1 and IASB's ED/2013/6, paragraph 25, propose to describe a lease term as:

[T]he noncancellable period of the lease, together with both of the following:

- a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option
- b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option

The current and proposed definitions of a lease term all begin with the noncancellable period of the lease term. The main differences when defining a lease term involve how to account for options. Current FASB literature provides significant detail on options. The IASB uses a "reasonably certain" threshold while the revised ED uses a "significant

economic incentive” threshold. The differences in defining a lease term in current literature and the proposed FASB and IASB literature will be further analyzed in Section C.

## **B. Governmental Accounting Standards Board (GASB)**

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, incorporates the provisions of FASB Statement 13, as amended and interpreted, into the GASB authoritative literature. GASB Statement 62, paragraph 271 defines a lease term as:

The fixed noncancelable term of the lease plus (1) all periods, if any, covered by bargain renewal options, (2) all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (3) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor’s debt directly or indirectly related to the leased property is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (4) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and (5) all periods, if any, representing renewals or extensions of the lease at the lessor’s option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be considered “noncancelable” for purposes of this definition.

This definition is substantially identical to the definition of a lease term in FASB Statement 13. However, it should be evaluated in light of the FASB’s proposed changes to the definition as discussed in the preceding section. The comparison between the

existing GASB literature and the FASB's revised ED are discussed in Section C of this paper.

In addition, Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, addressed how to treat renewal periods related to intangible assets, which some might analogize to this topic:

16. The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period to which the service capacity of the asset is limited by contractual or legal provisions. Renewal periods related to such rights may be considered in determining the useful life of the intangible asset if there is evidence that the government will seek and be able to achieve renewal and that any anticipated outlays to be incurred as part of achieving the renewal are nominal in relation to the level of service capacity expected to be obtained through the renewal. Such evidence should consider the required consent of a third party and the satisfaction of conditions required to achieve renewal, as applicable.

### **C. Staff Analysis**

When analyzing the current and proposed definitions of a lease term, there are two components of a lease term: (1) the noncancellable period and (2) periods covered by renewal or termination options. Both of these parts are discussed below and evaluated in detail to determine the lease term.

#### 1. Noncancellable Period

One of the similarities between the current standards and the FASB's revised ED is the notion that when defining a lease term, it should start with the noncancellable period. A noncancellable period goes with the idea of being legally enforceable and ties in with the Board's previous discussion of a contract versus an agreement. In the FASB's revised ED, "contract" is defined as "[a]n agreement between two or more parties that creates enforceable rights and obligations." The Basis for Conclusions (BC) of the

FASB's revised ED, paragraphs BC107 through BC111, describes the reasons for the use of the term contract in the definition of a lease. The term contract has an element of legal enforceability implied in the context and imposes rights and obligations on both parties which the courts have the authority to enforce. That premise also applies to this discussion because any noncancellable period of a lease term would create enforceable rights and obligations, meeting the definition of a contract, and therefore be included as part of the lease term.

The FASB's revised ED, paragraph 842-10-55-1, states that “[a] lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.” This statement makes it clear that when a lease is no longer enforceable, the noncancellable period would end.

One difference between current literature and the FASB's revised ED is removing the word “fixed” before noncancellable. The revised ED does not say why the word “fixed” was removed from the definition. However, the project staff does not view this as a significant modification and does not anticipate this to affect the determination of a lease term in any way.

One of the concerns raised by the FASB about defining a lease term by the noncancellable period involved entities creating leases that stated they could be cancelled at any time, with no expectation or intention to do so. This provision would eliminate any noncancellable period and decrease any liability required to be reported. The FASB rejected this argument based on the belief that this would not occur in practice due to the fact that the option to cancel a lease affects the price of that lease. A lessee is not going to be willing to pay a higher rate for a cancellable lease when there is no intention to cancel the lease in the near future and the lessor would not price a

cancellable lease at a lower noncancellable rate when they bear the risk of the lessee being able to legally cancel the lease.

The project staff believes that using the noncancellable period as the starting point when defining a lease term is appropriate and is consistent with the GASB's current literature.

### **Board Discussion Questions**

#### **Question 1**

##### **Should the definition of lease term continue to start with the noncancellable period?**

The project staff believes that the lease term definition should continue to start with the noncancellable period.

#### **Question 2**

##### **Should the word fixed be removed as an adjective describing the noncancellable period?**

The project staff believes the word fixed, as an adjective describing the noncancellable period, should be removed from the definition of lease term.

### **2. Option Periods**

Accounting for option periods is important because leases often include a provision that grants the lessee a right to extend a lease beyond the initial noncancellable period or terminate a lease after a specific point (the end of the noncancellable period), but before the end of the contract. The goal when accounting for option periods in a lease

term is to look at the substance over the form, make the best estimate of future events, and to dissuade artificially short noncancellable periods when all intents are to renew (or not terminate) the lease. The project staff believes there are three basic approaches when accounting for options in the lease term: include (i) none of the options, (ii) all of the options, or (iii) some of the options. A discussion on each approach in relation to the benefits and drawbacks of each method is provided below.

*i. Include None of the Options*

Excluding all renewal and termination options and only including the noncancellable period in the lease term is one possible solution. The project staff believes that the main advantages to this approach would be simplicity and limiting the lease term to only the current rights and obligations under the contract instead of trying to predict what may happen in the future with an option. The downside to this approach is that it could be seen as not faithfully accounting for the lease in its entirety and could possibly misrepresent any assets or liabilities that would be recognized. In the FASB's revised measurement provision proposal, a lessee's recorded liability (or a lessor's recorded receivable) could be much less (outside of any discount factor) than the future payments the entity really expects or intends to make (or receive). If a lease has an option and the intent of the lessee is to exercise that option or the option is so beneficial that there is little doubt about exercising that option, it would seem inappropriate to exclude that option from the lease term. Additionally, the exclusion of all options periods from the lease term could provide an incentive for lease contracts to include more renewal options with a shorter noncancellable period.

Besides ignoring the options completely, two variations of this approach include a components approach and a disclosure approach. A components approach recognizes and measures the options in a lease as separate components of the lease, separate from the noncancellable period. This approach creates added complexity when accounting for leases and it ignores the interrelationship that exists between the noncancellable

term of the lease and the option; that is, there would not be an option without the rest of the lease. Additionally, the government would still have to make a determination of which options to include in the separate component.

A disclosure approach would include only the noncancellable period in the lease term and disclose any options after that. One FASB member supports this approach, which is described in an alternative view (BC 364) in the FASB's ED. That board member thought that not including the options, but rather requiring disclosures on those options, would simplify the proposal. While this approach reduces complexity, it also could misrepresent any assets and liabilities that are created by a lease due to ignoring options that are almost certain of being exercised.

*ii. Include All of the Options*

Including all of the options to renew or terminate is another way to handle them with respect to the lease term. A benefit to this approach is simplicity due to the fact that it eliminates judgment about which options to include. However, including all of the options in the lease term may overstate (if renewal options) or understate (if termination options) assets and liabilities, just as including no options would understate (if renewal options) and overstate (if termination options) the assets and liabilities.

In the project staff's view, a lease term should reflect a government's reasonable expectation of how long the lease will be in effect. This also was the Boards' view on renewal periods in the basis for conclusions of Statement 51: "the Board believes that these renewal periods should be considered in determining the useful life of intangible assets in situations in which the renewal is expected to be pursued and achieved, and serves as an extension of the existing asset" (paragraph 77). Including or excluding all renewal or termination options would likely not be a faithful representation.

*iii. Include Some of the Options*

Including some of the options on the basis of a measurement approach is a third possible solution when defining a lease term. The alternatives here include a probability-weighted measurement method, a probability threshold method, and an economic incentive method. These are alternatives considered by the FASB, as described in paragraph BC137c of the ED.

Probability-Weighted Measurement Method

A probability-weighted measurement method reflects the probability of each possible lease term. This would be “payments expected to be made,” a view expressed in an alternative view by one of the IASB members (BC 403). That IASB member believes that having a “significant economic incentive” (the threshold for including options used in the revised ED, discussed later in this paper) is too high of a hurdle and would not reflect the economics of a lease that included an option. One of the advantages of using this method is that there is already a precedent for using it in the GASB literature. This method is required by GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, when measuring environmental liabilities. This approach is an expected cash flow technique and is defined in Statement 49 as follows:

A technique that measures a liability as the sum of probability-weighted amounts in a range of possible estimated amounts—the estimated mean or average. This technique uses all expectations about possible cash flows.

One of the negatives to this approach is the complexity that this would create when applying this method. Conceptually, this may seem like an appropriate approach if an entity is trying to estimate how long the term of the lease will be, but practically it may be too costly to implement. In order to apply this approach, an entity would have to assess and estimate the probability of each option period in a lease for all of their leases. This method’s complexity is greater than the probability threshold methods,

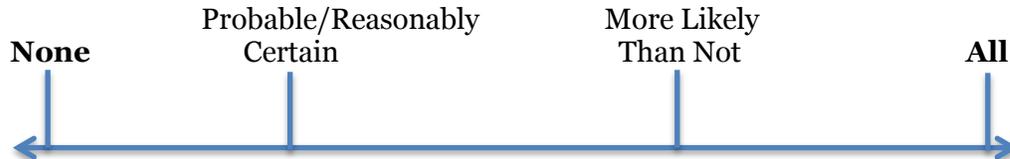
discussed next, because it requires an entity to quantify their considerations, which is more time consuming than simply analyzing the circumstances.

### Probability Threshold Method

A probability threshold method includes an option if it has a certain likelihood of occurrence. There are a number of different thresholds that could be used, including:

- 1.) More Likely Than Not or
- 2.) Probable/Reasonably Certain

Each of these probability threshold approaches will be discussed below, highlighting the benefits and drawbacks of each. The following diagram is provided to illustrate the spectrum of options that could be included in a lease term.



The benefit of using a probability threshold is it allows a government to base its lease term on a reasonable expectation of how long the lease will be in effect. Therefore, it could result in a better estimate of any recorded assets and liabilities.

A downside of using probability thresholds is that they use management's expectations as a basis for making the assessment. These can be subjective, difficult to verify, and subject to frequent changes. If the Board tentatively decides that lease terms should be reassessed at some point (a question to be discussed later in this paper), management's expectations could change and result in frequent remeasurement of any lease assets or

liabilities. The assessment of probability could also be a time-consuming process for governments that have hundreds, or even thousands, of lease contracts.

A possibility to counteract the subjectivity of management's expectations and intent could be to use a probability threshold in conjunction with an assessment of qualitative factors, similar to the approach used in Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. Such factors could be more objective items like an economic incentive to exercise the option (also a stand-alone approach discussed later in the paper), past history in exercising options, and programmatic or policy incentives (such as continuing to maintain space in a low-income area to operate a county health clinic in the neighborhood where those services are needed). If an assessment of these factors leads to the likelihood of an option being exercised as above the probability threshold, those option periods would be considered part of the lease term.

The requirement in Statement 51 to include renewal periods in the useful life of an intangible asset based on "evidence that the government will seek and be able to achieve renewal" also is a threshold based on management's expectations. However, the project staff believes there is a difference between seeking renewal of an intangible asset from a regulatory agency and negotiating a renewal of a lease in an exchange transaction. In an intangible renewal, there is an established set of criteria for renewal (perhaps an application form or checklist), and the government only has to meet those criteria for renewal. In a lease, there could be negotiation as both parties to the lease seek the most beneficial terms. Because of that, the project staff believes that the government seeking and expecting to achieve renewal would not have the same meaning in the context of a lease and therefore would not be appropriate to use as a threshold for evaluating lease renewal options.

### 1.) More Likely Than Not Threshold

In the FASB's original ED, the probability threshold used was "more likely than not." Under this approach, the lease term would be the longest possible term that is more likely than not to occur. One FASB member believes that this is still the most appropriate approach, as described in his alternative view (BC 385). That FASB member asserts "that the measurement of the lessee liability should include those uncertain amounts for the information to be decision useful."

There also is precedent in GASB literature for this method. Statement No. 70 uses the "more likely than not" threshold for recognition of a liability. The term "more likely than not" means a likelihood of more than 50 percent when used in this statement. One of the benefits of using this criteria in Statement 70, in the Board's view, was that a "more likely than not" criterion eliminates some of the concerns about the point at which a liability is recognized. Statement 70's use of "more likely than not" creates a bright-line test, more than 50%, to determine when a liability is recognized. Although the approaches and calculation to arrive at an estimate may be different, the concerns of accounting for the same estimate in different ways would be alleviated under this approach due to the bright-line test. The Board also noted that using this criterion would require the application of professional judgment in assessing probability. By extension, using "more likely than not" to evaluate which options to include in a lease term would still require judgment as to the likelihood of their being exercised. However, using "more likely than not" eliminates a second layer of judgment as to interpretation of what that requirement means.

One of the negatives to the more likely than not threshold is that it uses a bright-line test and that, if the probability of exercise can be measured that precisely, small variations in the estimated probability could result in lease options with similar characteristics being handled differently for the lease term. For example, the estimated

likelihood for one option may be 51 percent and another option may be 49 percent and even though these options would have similar characteristics, one would be included in the lease term and the other would not. Although the project staff recognizes that a probability would not likely be measured that precisely, this illustrates one of the main problems of using a bright-line test and the fact that a small change can alter the accounting treatment. An entity that desires to achieve a certain outcome has a greater ability to achieve that outcome when following a bright-line test.

## 2.) Probable/Reasonably Certain Threshold

Two other thresholds that may be used when accounting for options are the terms “probable” or “reasonably certain.” The threshold of “reasonably certain” is the current threshold used in the IASB lease literature, while a threshold of “probable” is used in FASB and GASB literature for assessing contingencies. In Statement 62, as well as in FASB Statement No. 5, *Accounting for Contingencies*, the term probable is defined as the future event or events that are likely to occur. These thresholds are discussed together because they are difficult to differentiate and both result in similar results when defining a lease term.

There also is existing precedent for this threshold in current GASB literature, and it applies in a broader range of circumstances than more likely than not. A renewal or termination option could be seen as a type of contingency and the term probable is used for recognizing loss contingencies in Statement 62. A contingency is defined in statement 62, paragraph 96 as:

[A]n existing condition, situation, or set of circumstances involving uncertainty as to possible gain (referred to as a gain contingency) or loss<sup>37</sup> (referred to as a loss contingency) to a government that will ultimately be resolved when one or more future events occur or fail to occur.

<sup>37</sup>The term *loss* is used for convenience to include many decreases in net position/fund balances that are commonly referred to as

expenses/expenditures and others that are commonly referred to as losses.

The lease contract is an existing condition, and there is uncertainty regarding whether or not renewal or termination options will be exercised and result in a gain (lessor) or loss (lessee), using those terms loosely (based on the description in the footnote above) for additional payments to be received or made. That uncertainty will be resolved when the future decision is made to exercise or not exercise those options. However, it should be noted that using probable would provide consistency only for lessees due to the fact that there is a higher threshold that is used in Statement 62 for gain contingencies which would equate to the lessor in lease literature. In Statement 62, gain contingencies are disclosed, but are not recognized due to the possibility of recognizing revenue prior to realization. Therefore, a lessor using “probable” to evaluate lease options would be using a different standard than if it were following the general contingency guidance.

A benefit of using either of these thresholds (probable or reasonably certain) would be that it may create less inconsistency within the same government when applying these thresholds to the lease term. Unlike the bright-line test of “more likely than not,” these two thresholds may be more likely to result in the same treatment for options that have similar characteristics, if judged by the same management. Without the bright line, a slight variation in circumstances would be less likely to make one option fall to the other side of the threshold (though an individual government may establish its own bright-line policy defining probable). However, due to the additional layer of judgment that both of these terms would require (because there is no bright line), it may lead to different applications of accounting for lease options between different governments, and even between lessee and lessor. When there are no parameters around what exactly is meant by “probable” or “reasonably certain,” it creates added complexity that could be eliminated. For example, the term “more likely than not” is defined as greater than a 50 percent chance. This still requires judgment when determining the probability of

exercising an option; however, as previously noted, a government knows that if the estimate is greater than 50 percent it should be included. On the other hand, a government may come up with the same probability estimate and account for the option in two different ways under the “probable” or “reasonably certain” threshold because probable and reasonably certain may mean different things to different people.

An additional downside to the term “reasonably certain” is that it is currently not in the GASB literature and it would be creating another threshold that essentially would evaluate options in a lease term in the same manner as the threshold “probable.”

#### Economic Incentive Method

In the FASB’s revised ED, the proposed standard was modified, based on user feedback, to include options if the entity has a “significant economic incentive” to exercise the option. The majority of the FASB’s members believes that an economic incentive threshold can be applied more easily than probability thresholds while at the same time providing more objectivity. This threshold would not be based largely on management’s intent and would therefore help address cost and complexity as well. The ED provides factors to consider, which are provided below, that reduce the subjective intent by providing financial characteristics as well as one qualitative characteristic that would demonstrate a “significant economic incentive.” Financial or quantitative characteristics provide more objectivity and verifiability than that of qualitative characteristics such as management’s intent or other similar factors that are hard to assess.

The FASB sees this threshold as very high and would result in few options to be included in the lease term because an expectation of exercising the option, even if it is almost certain, would not be sufficient without a significant economic incentive as well. The FASB’s ED outlines the inclusion of lease options on the basis of whether there is a

significant economic benefit to exercise the option. Example factors to be considered are provided:

#### 842-10-25-2

At the commencement date, an entity shall consider contract-based, asset-based, entity-based, and market-based factors when assessing whether a lessee has a significant economic incentive either to exercise an option to extend a lease or not to exercise an option to terminate a lease, as described in paragraph 842-10-55-4. Those factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee has a significant economic incentive to exercise, or not to exercise, the option.

\* \* \* \* \*

#### 842-10-55-4

At the commencement date, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option by considering all factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment will often require the consideration of a combination of those factors because they are interrelated. Examples of factors to consider include, but are not limited to, any of the following:

- a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
  1. The amount of lease payments in any optional period
  2. The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees
  3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable.
- c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs

- associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.
- d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

This provides an understanding of what it means to have a significant economic incentive and how an entity would determine its existence. The project staff believes that this would reduce the amount of professional judgment required, but to what extent is difficult to determine.

A downside of this method is that economic incentives may be less important to governments in the decision to exercise lease options than they are to a private sector company. A company generally would not take a course of action if it were not economically beneficial to the company. However, governments sometimes make decisions based on policy or service needs, the outcome of which would have been different if the decision were based solely on the economics of the transaction. Therefore, the threshold of significant economic incentive for assessing lease options could be seen as less relevant in the government sector than the private sector.

#### Staff Recommendation

The project staff believes that each of the alternatives described above has benefits and drawbacks, and there has been strong disagreement among the FASB and IASB and their constituents as to how lease options should be considered in the lease term. Recognizing there is no perfect answer, the project staff believes that a probability threshold with example qualitative factors may be the best option. The factors would help counteract the subjectivity of an assessment based on management's intent or expectations. The project staff believes that a probability threshold of probable should be used because it is generally seen as a higher bar than more likely than not (though there is disagreement on this point). This would be preferable because the current

FASB, GASB, and IASB literature already set a fairly high threshold for inclusions of options, as does the FASB and IASB's proposal.

### **Board Discussion Question**

#### **Question 3**

**How should periods covered by options to renew or terminate a lease be incorporated into the determination of the lease term?**

The project staff believes that the lease term definition should include options that are probable of being exercised based on an assessment of qualitative factors.

### **III. FISCAL FUNDING AND CANCELLATION CLAUSES**

Many contracts entered into by governments contain clauses that the contracts may be cancelled if funds are not appropriated for that item in a future period. These are referred to in accounting literature as fiscal funding or cancellation clauses.

#### **A. FASB and IASB**

##### **FASB**

The fiscal funding clause, provided in the FASB's literature for companies leasing to government entities, is defined below by the FASB's Master Glossary:

A provision by which the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

Original guidance for fiscal funding clauses was issued in the FASB Technical Bulletin (TB) 79-10, *Fiscal Funding in Lease Agreements*, which confirms that fiscal funding clauses are “commonly found in a lease agreement in which the lessee is a governmental unit.” Paragraph 5 of the TB discusses the effect of fiscal funding clauses on lease terms as:

The existence of a fiscal funding clause in a lease agreement would necessitate an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise of the fiscal funding clause is assessed as being remote, a lease agreement containing such a clause would be considered a noncancelable lease; otherwise, the lease would be considered cancelable and thus classified as an operating lease.

This paragraph was codified into Topic 840-10-25-3.

The FASB’s most recent ED proposes removing the fiscal funding and cancellation provision from the Leases Topic. It retains the similar provision that is found in Topic 985, *Software–Revenue Recognition*, with an amendment to remove the analogy to lease literature:

~~Consistent with a paragraph 840-10-25-3, a~~ A software licensing arrangement with a governmental unit containing a fiscal funding clause shall be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. The evaluation of whether the level of uncertainty of possible cancellation is remote shall be consistent with Topic 450, which defines remote as relating to conditions in which the chance of the future event or events occurring is slight.

If the likelihood of cancellation is assessed as remote, the software licensing arrangement shall be considered noncancelable. Such an assessment shall include the factors discussed in paragraphs 985-605-25-33 through 25-34. If the likelihood is assessed as other than remote, the license shall be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements

of the clause and all other provisions of this Subtopic have been satisfied. [985-605-25-39 and 40; proposed revision in ED]

The Basis for Conclusions does not address the reason for this change. However, the FASB's ED explains how to assess a lease term when one party has the right to terminate or extend the lease in paragraph 842-10-55-2 as follows:

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-25-1.

Although the specific fiscal funding clause provision has been removed, such a clause would give only the lessee government the right to terminate the lease. Therefore, these situations are covered under the general FASB proposal to classify all lessee rights to terminate a lease as options.

## **IASB**

The IASB does not address fiscal funding and cancellation clauses in their current literature. However, the IASB's ED uses identical language to the FASB's ED paragraph 842-10-55-2, stated above, regarding one party having the right to extend or terminate the lease. Therefore, leases with fiscal funding or cancellation clauses can be considered as optional periods.

## **B. GASB**

Current GASB literature details the reasoning behind fiscal funding and cancellation clauses. In order to permit governmental lease agreements, these clauses are added as a means to cooperate with legal restrictions, specifically related to debt limitation and debt incurrence. The National Council on Governmental Accounting Statement (NCGAS) 5, *Accounting and Financial Reporting Principles for Lease Agreements of*

*State and Local Governments*, paragraph 18 explains the purpose of fiscal funding and cancellation clauses, as written below:

One type of legal restriction relates to debt limitation and debt incurrence which prohibits governments from entering into obligations extending beyond the current budget year. Because of this type of restriction, governmental lease agreements typically contain a fiscal funding or cancellation clause, which permits governmental lessees to terminate the agreement on an annual basis if funds are not appropriated to make required payments.

The GASB literature indicates that the economic substance of most lease agreements are long term contracts, notwithstanding fiscal funding or cancellation clauses. Furthermore, the economic substance, not legal form, should be evaluated when determining a lease term. As specified in NCGAS 5 paragraph 5:

The economic substance of most lease agreements with fiscal funding or cancellation clauses is that they are essentially long-term contracts. The potential for cancellation of most government lease agreements is remote, i.e., routine cancellations of such agreements would discourage potential lessors from entering into such lease agreements with the government in question and may have an adverse impact on the receptivity of investors to other obligations of that government. In substance, notwithstanding the fiscal funding clause, the economic substance of lease agreements should be considered instead of the legal form.

In the project staff's view, the effect of the economic substance over form criterion should dissuade governments from classifying a lease with a fiscal funding or cancellation clause as short-term when there is a remote possibility of cancellation.

## **C. Other Standard Setters**

### **Federal Accounting Standards Advisory Board (FASAB)**

The FASAB's *Handbook of Federal Accounting Standards and Other Pronouncements, as Amended, as of June 30, 2012*, does not refer to fiscal funding or cancellation clauses in any Statements of Federal Financial Accounting Standards.

### **International Public Sector Accounting Standards Board (IPSASB)**

The IPSASB's International Public Sector Accounting Standards No. 13, *Leases*, does not include reference to fiscal funding or cancellation clauses.

## **D. Staff Analysis**

The project staff identified two approaches to treat fiscal funding and cancellation clauses when determining a lease term. First, current guidance can remain in effect, with any clauses not meeting the "remote" threshold being considered as options to terminate under the guidance discussed in Question 1. Project staff agrees with the current guidance related to leases with fiscal funding and cancellation clauses. If the probability of exercising a fiscal funding or cancellation clause is "remote," the period covered by the clause should be considered part of the noncancellable period of the lease. Statement 62, paragraph 100 describes the term "remote" to indicate that "[t]he chance of the future event or events occurring is slight." A consideration to using this "remote" threshold is the professional judgment required to determine whether or not the option should be defined as "remote." Although this term considers qualitative factors that are consistent with management's intent, the project staff believes this is necessary criteria.

Although the FASB removed the fiscal funding clause provision from its lease literature, that provision is less relevant to a corporate environment and therefore is less likely to have a significant impact on the private industry. A contract between two companies would not include fiscal funding or cancellation clauses unless there are special circumstances where there is a possibility of it needing to be exercised. On the other hand, governments often have the legal requirement to include fiscal funding and cancellation clauses in all leases, even if there is no expectation to terminate the lease. Governments do not often exercise these clauses, and doing so would cause lessors to charge higher rates because of that risk. Because this clause may be a perfunctory non-negotiable element of a lease, the project staff believes management's intent is important to consider when assessing the possibility of termination. Even though "remote" is not associated with a more objective threshold, the term is consistent with current GASB literature.

The project staff believes fiscal funding and cancellation clauses not considered to be "remote" should be treated as termination options. Therefore, clauses that have a more-than-remote possibility of exercise would be considered in the lease term in accordance with the tentative decision made in Part 1 of this paper. Based on the staff recommendation, if it is assessed that it is probable that the government would terminate the lease, the periods covered by the cancellation clause would be excluded from the lease term.

The second alternative, consistent with the FASB's proposal, is that all rights to termination could be treated as termination options. Because fiscal funding and cancellation clauses permit one party to cancel the lease without approval of the other party, the lease's term would include this as an optional period. This approach would determine a lease term by including fiscal funding and cancellation clauses that meet the threshold discussed in Part 1. The difference is that any situation where management's intent or expectation is a remote possibility of exercising the clause

would instead be subject to the probability threshold recommended in Part 1 of this paper. This could result in a difference in assessment. This approach is also contrary to the reasoning behind the current provision; that is, substance over form. As discussed above, the project staff believes management's intent is an important criterion when determining whether or not to classify a fiscal funding or cancellation clause as an option, especially because these clauses are found in many government leases. Therefore, the project staff finds the first alternative to be the better choice, and believes this is an area where there is justification for a difference from the FASB's proposal.

### **Board Discussion Question**

#### **Question 4**

#### **How should fiscal funding or cancellation clauses be treated for purposes of determining the lease term?**

The staff believes determining the lease term for a lease with fiscal funding and cancellation clauses should remain consistent with current GASB literature. If the possibility of cancellation is remote, the periods covered by the clause should be included in the noncancellable period. If the possibility of cancellation is more than remote, such a clause should be treated as any other termination option in determining the lease term.

### **CHANGES OR AMENDMENTS TO LEASE TERMS**

The importance of the lease term concept to classification (and later, the measurement principles in the FASB's ED) raises another issue--how to deal with events that would change the period of time covered by the lease. This could be formal changes to the

contract, such as exercising a renewal option. There also could be a reassessment of the lessee's likelihood to exercise renewal or termination options. This section only applies to changes to the period of time covered by the lease.

Based on the definition the FASB has proposed, the lease term is an estimate that is based in part on judgment about future events. Because of that, as described in paragraphs BC 168-172 of the ED, the FASB believes that reassessment is sometimes necessary. However, the FASB believes that requiring reassessment at each reporting date would be unnecessarily costly. Therefore, it has proposed that the lease term only should be reassessed in certain situations:

**842-10-25-3** An entity shall reassess the lease term only if either of the following occurs:

- a. There is a change in relevant factors, as described in paragraph 842-10-55-5, that would result in the lessee having or no longer having a significant economic incentive either to exercise an option to extend the lease or not to exercise an option to terminate the lease. A change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term.
- b. The lessee does either of the following:
  1. Elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so
  2. Does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

The above quote references ASC 842-10-55-5, which in turn references paragraph 4 above it for the relevant factors. That paragraph is quoted earlier in this paper and is repeated here for ease of reference:

842-10-55-4

At the commencement date, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option

by considering all factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity’s assessment will often require the consideration of a combination of those factors because they are interrelated. Examples of factors to consider include, but are not limited to, any of the following:

- a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
  1. The amount of lease payments in any optional period
  2. The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees
  3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable.
- c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee’s operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.
- d. The importance of that underlying asset to the lessee’s operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

The current FASB literature that addresses the subject of lease renewals is in ASC 840-10-35-4. The paragraph came from FASB Statement 13, and therefore also is found in GASB in Statement 62. This quotation is from GASB Statement 62, paragraph 215:

If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 213 and 214 had the changed terms been in effect at the inception of the lease, the revised agreement should be considered a new agreement over its term, and the criteria in paragraphs 213 and 214 should be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered

inoperative as described in paragraph 218 and 224e, any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, should be considered a new agreement, which should be classified according to the provisions of paragraphs 212–214. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, should not give rise to a new classification of a lease for accounting purposes. [underlining added]

Current FASB Literature also provides guidance for when a renewal or extension should be considered for reassessing if an agreement contains a lease. This came from Emerging Issues Task Force (EITF) Abstract 01-08. Because EITFs were not included in the FASB literature codified by GASB Statement 62, the GASB does not have a parallel to this guidance.

A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any of the following conditions exist:

\* \* \* \* \*

b. Renewal or extension. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated only with respect to the renewal or extension period. The accounting for the remaining term of the original arrangement shall continue without modification. The exercise of a renewal option that was included in the lease term at the inception of the arrangement shall not be considered a renewal for the purpose of reevaluating the arrangement. Accordingly, the exercise of the renewal option shall not trigger a reassessment. [FASB ASC 840-10-35-2]

### **Staff Recommendation**

The FASB's proposed guidance on when to reassess the lease term seems appropriate in light of its proposed definition of a lease term. Because that definition requires more judgment than the current definition, it follows that reassessment may be necessary with changes in circumstances. It also seems appropriate that the renewals would be

considered a change in estimate, rather than treated as a new agreement like the current literature.

The project staff notes that basing reassessment on a change in relevant factors would require periodic evaluation of those factors, which would likely have the same result of a reassessment at each reporting date. Particularly in larger governments, the financial reporting staff may not always be aware of changes in relevant factors and would have to actively seek out that information. However, this is similar to other estimates that are reevaluated regularly as part of the financial reporting process. If there have been no changes in the relevant factors, there would be no need to do anything further. Additionally, the other requirement to reassess lease term when the lessee actually renews or terminates contrary to previous expectation seems to be a logical time to reevaluate the estimate.

### **Board Discussion Questions**

#### **Question 5**

##### **When should a government reassess the lease term?**

The project staff believes that the lease term should be reevaluated when there is a change in relevant factors that would result in a change in judgment as to the lessee's likelihood to exercise or terminate the lease, or when the lessee actually exercises or terminates the lease opposite of what was previously expected.

#### **Question 6**

##### **What factors should trigger a reassessment of the lease term?**

The project staff believes the relevant factors used in the initial assessment also should be the factors that trigger a reassessment

1     **DRAFT OF A STANDARD**

2  
3     **Lease Term**

4  
5     XX.    The lease term is the noncancellable period for which a lessee has the right to  
6            use an underlying asset, plus:

- 7            a. Periods covered by an option to extend the lease if it is probable, based on  
8                 qualitative factors, that the lessee will exercise that option  
9            b. Periods covered by an option to terminate the lease if it is probable, based on  
10                qualitative factors, that the lessee will not exercise that option.  
11

12    XX.    At the beginning of a lease, a government should assess qualitative factors  
13            relevant to the likelihood that the lessee will exercise options—contract-based,  
14            asset-based, market-based, and government-specific factors. The government’s  
15            assessment will often require the consideration of a combination of those  
16            factors because they are interrelated. Examples of factors to consider include,  
17            but are not limited to, any of the following:

- 18            a. A significant economic incentive, such as contractual terms and conditions  
19                 for the optional periods that are favorable compared with current market  
20                 rates.  
21            b. The lessee’s history of exercising renewal or termination options.  
22            c. The importance of the lease to the government’s services.  
23            d. Costs relating to the termination of the lease and the signing of a new lease,  
24                 such as negotiation costs, relocation costs, costs of identifying another  
25                 underlying asset suitable for the lessee’s operations, or costs associated with  
26                 returning the underlying asset in a contractually specified condition or to a  
27                 contractually specified location.  
28

29    XX.    A government should reassess the lease term only if either of the following  
30            occurs:

- 31            a. There is a change in relevant factors, as described in the preceding paragraph,  
32                 that would result in the likelihood of the lessee exercising an option to extend  
33                 the lease or not exercising an option to terminate the lease becoming  
34                 probable or no longer being probable. A change in market-based factors  
35                 (such as market rates to lease a comparable asset) shall not, in isolation,  
36                 trigger reassessment of the lease term.  
37            b. The lessee does either of the following:

- 38 1. Elects to exercise an option even though the government had previously  
39 determined that it was not probable that the lessee would do so  
40 2. Does not elect to exercise an option even though the government had  
41 previously determined that it was probable that the lessee would do so.  
42

### 43 **Fiscal Funding or Cancellation Clauses**

- 44  
45 XX. If the likelihood of lease cancellation under a fiscal funding clause is remote, the  
46 government should consider the periods covered by that clause to be part of the  
47 noncancellable period of the lease. If the likelihood is more than remote, the  
48 government should consider the periods covered by that clause to be  
49 termination options subject to the requirements of paragraph XX for inclusion  
50 in the lease term.

### **Board Discussion Question**

#### **Question 7**

**What modifications, if any, would the Board make to the draft text shown above?**

The project staff believes the draft text illustrates the recommendations made previously in the paper.



## MEMORANDUM

**Issue 6, Paper 2**  
**March 2014 Meeting**

**To:** Board Members and David Bean  
**From:** Deborah Beams, Randy Finden, Jialan Su, Ken Schermann, Christopher Teats, Cody Domasky  
**c:** GASB Staff, Task Force Members, and Meeting Observers  
**Date:** February 18, 2014  
**Re:** Leases Project: Foundation of Lessor Model

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### INTRODUCTION

With a tentative lessee accounting model largely developed, the project staff has started to turn its attention to lessor accounting. There are some foundational questions to consider before discussing the details of a lessor accounting model. The joint meeting with the Federal Accounting Standards Advisory Board (FASAB) provides an opportunity for the FASAB and the GASB to discuss these foundational questions together as they relate to the Boards' respective governmental environments. This paper presents issues relating to changing the existing lessor accounting model and the importance of symmetry between lessee and lessor accounting.

### CHANGING THE EXISTING LESSOR MODEL

#### **Current Lessor Model and FASB and IASB Proposal**

Under both Financial Accounting Standards Board (FASB) and GASB literature, current accounting by lessors follows one of three models: sales-type, direct financing, or operating. Sales-type and direct financing leases are the counterparts to the lessee's capital lease. In both of these scenarios, the lessor recognizes an asset and liability associated with the lease. Accounting for an operating lease by a lessor mirrors the accounting for an operating lease by a lessee. No asset or liability is recognized and payments received are recognized as revenue over the lease term (either on a contractual payment basis or straight-line basis). Current literature of the International

Accounting Standards Board (IASB) includes two models for lessors: financing leases, which result in recognition of an asset and liability, and operating leases, which do not.

The FASB and IASB's revised Exposure Draft (ED), *Leases*, has proposed to use the same lease classifications, Type A and Type B, for lessor accounting as well as for lessee accounting. Accounting for the Type A lease would involve recognition of a lease receivable and interest in the residual asset, derecognition of the underlying asset, and upfront revenue recognition for the entire arrangement. Accounting for the Type B lease would involve revenue recognition over the term of the lease, without recognition of a lease receivable or derecognition of the underlying asset. This would be similar to the current operating lease model.

### **Reasons for Changing Current Lessor Model**

One reason given by the FASB and IASB for proposing changes to lessor accounting is to provide more information about certain risk exposures faced by lessors. Paragraph 3.c. in the Basis for Conclusions of the revised ED describes these risks:

Some users have also criticized the existing requirements for lessors because they do not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from its retained interest in the underlying asset), particularly for leases of assets other than property that are currently classified as operating leases.

Another reason for changing the current lessor model is the classification requirements. Lease classification by lessors includes the same bright-line tests that lessees use to make the capital versus operating lease decision. As discussed during deliberations of lessee accounting, this has been the subject of much criticism for the ability to structure leases to achieve a desired accounting result. While not directly mentioned in the FASB and IASB's revised ED, paragraph 78.a. of the Basis for Conclusions alludes to this structuring by describing companies that account for similar leases in different ways.

In the Boards' view, the changes being proposed for lessors with leases of assets other than property will improve financial reporting. For example, a financial institution lessor (leasing equipment or vehicles) would be expected to recognize interest income over the lease term of all of its leases over 12 months, reflecting that the lessor is primarily engaged in providing finance to lessees. According to existing requirements, that lessor is likely to account for some of those leases as financing transactions (that is, finance leases) and some as operating leases (recognizing rental income on a straight-line basis, rather than interest income). In addition to recognizing interest income, a manufacturer lessor (leasing equipment or vehicles) is likely to recognize revenue and cost of sales at the commencement date, similar to how the lessor recognizes revenue and cost of sales on sales of similar assets. The manufacturer lessor would, however, only recognize revenue and profit relating to the right-of-use asset transferred to the lessee, rather than revenue and profit on the entire leased asset. That accounting would reflect that a manufacturer lessor often uses leasing as an alternative means of realizing value from assets that it would otherwise sell. According to existing requirements, that lessor is likely to account for some of its leases as finance leases and some as operating leases resulting in very different accounting outcomes, even though it is likely to price all of its leases in a similar way.

In a similar vein, the GASB's Leases task force indicated some complexities with the current classification requirements, specifically making the determination between sales-type and direct-financing leases.

In addition to criticisms of the current lessor accounting model, some of the tentative decisions made to date in the Leases project indicate that conforming changes should be made to lessor accounting. As the FASB and IASB noted in paragraph 78.c. of the Basis for Conclusions to the revised ED:

It would be difficult, if not impossible, not to make *any* changes to lessor accounting in light of the changes being made to lessee accounting, for example, changes to variable lease payments and the definition of a lease. Consequently, if any improvements could be made to lessor accounting, it would be appropriate to make those improvements at this time.

One reason to make changes to lessor accounting based on the tentative decisions for lessee accounting is the notion of symmetry. With a lessee and lessor being two sides of the same transaction, having the accounting for each side mirror the other in concept could be a desired result. The notion of symmetry will be discussed in more detail in the next section of this paper.

Another reason to make changes to lessor accounting is the Board's tentative decision to propose the underlying notion that leases are financings. If the Board considers this notion to be foundational to the substance of a lease, it would follow that lessor accounting should be evaluated against that notion. This also follows the notion of symmetry. While the FASB and IASB's revised ED acknowledges feedback from constituents that view leases as financings, no official position of the Boards on that topic is expressed. However, one IASB member remarked in the January 2014 joint meeting with FASB that while the current lessor accounting may work, it is inconsistent with the view of leases as financing arrangements. Additionally, paragraph 78.b. of the revised ED's Basis for Conclusions argues for consistency in the rationale supporting lessee and lessor accounting.

Without any change to lessor accounting, an entirely different rationale would be used to support the lessee and the lessor accounting proposals. Respondents to both the Discussion Paper and the 2010 Exposure Draft had requested consistency in the rationale supporting both the lessee and lessor models, with many noting subleases as a reason for this request.

Other reasons given by the FASB's constituents in due process feedback regarding the need to make changes to lessor accounting include 1) conforming to the FASB's forthcoming revenue recognition standard, and 2) creating a fully converged standard with the IASB. The project staff notes that these concerns do not apply to the GASB's project. (While the GASB and the FASAB are collaborating on their respective Leases projects, the Boards are making decisions independently and do not have the objective of creating a converged standard between one another. Similarly, while the GASB staff

and FASB staff are collaborating by sharing ideas, creating a converged standard is not necessarily a goal of the projects.)

### **Reasons against Changing Current Lessor Model**

The FASB and IASB's revised ED acknowledges that not everyone shares the view that changes to current lessor accounting are needed.

BC9. The main feedback received on the proposals included in the 2010 Exposure Draft was as follows:

\* \* \* \* \*

c. Many respondents disagreed with the lessor accounting proposals:

\* \* \* \* \*

4. Others said that the existing lessor accounting requirements work well in practice and supported retaining those requirements.

One of the FASB members supported not changing current lessor accounting in his alternative view.

BC381. While [this Board member] has primarily addressed his concerns from the lessee perspective, he believes the same concerns apply to the proposed requirements for lessors. He also believes that, from a user perspective, the existing lessor accounting requirements work well in practice. Taken as a whole, [this Board member] does not believe there is sufficient improvement to justify incurring costs to implement the proposed requirements as they relate to lessors. Therefore, he supports retaining current lessor accounting requirements.

Since the issuance of the revised ED, the FASB and IASB have received a considerable amount of feedback that urged the Boards not to make major changes to the current lessor accounting model. Many of their constituents expressed views that the current requirements are adequate and there is no need to make significant changes. They cite the fact that many users do not make adjustments to financial statements of lessors as

they do with lessees. The major criticism of lessee accounting is the perceived unrecognized liability, which is not a concern voiced about lessor accounting. While no decisions have been made, the FASB and the IASB have discussed options for a lessor accounting model that would only make minor changes to the current requirements, rather than the overhaul proposed in the revised ED.

Additionally, feedback from the GASB's Leases task force did not indicate specific concerns with current lessor accounting other than classification, as discussed earlier in the paper. The project staff also reviewed technical inquiry logs and found very few regarding accounting by a lessor, which suggests that the current guidance works in practice.

### **Project Staff Analysis**

Though certain stakeholders may not view the current lessor accounting guidance as broken and in need of fixing, as they view lessee accounting, the project staff believes that the Board should consider a new model for lessor accounting. Because of the changes to lessee accounting that the Board has tentatively decided to propose, especially the underlying notion of leases as financings, the project staff believes that lessor accounting should be deliberated. This not only would allow the Board to determine an appropriate lessor accounting model, but also could help further examine tentative positions taken on lessee accounting and financial reporting issues

### **Board Discussion Question**

#### **Question 1**

#### **Should a new model for lessor accounting be considered?**

The project staff recommends that the Board consider a new model for lessor accounting.

## **SYMMETRY BETWEEN LESSEE AND LESSOR**

The previous section of this paper mentioned the notion of having symmetry in lessee and lessor accounting. For example, if a lessee has a liability related to a certain transaction, then the lessor would have an equal receivable. This discussion relates to symmetry between a lessee's accounting and a lessor's accounting for the same transaction when both parties follow governmental accounting standards (that is, both follow GASB or both follow FASAB). Symmetry when each party follows the guidance of a different standard setting body is not likely to be achieved, nor is that a goal of the Leases project.

### **Arguments for Symmetry**

Many have argued for a need to have symmetry between the lessee and lessor accounting models. It makes sense for each party to a transaction to have mirror-image accounting. Many transactions have symmetry. When purchasing goods or services, generally one party has expense and cash outflow and the other has revenue and cash inflow for the same amount. As one IASB member mentioned at the January joint meeting with FASB, if the lessee is "buying" the right to use the underlying asset, then the lessor must be "selling" it. In theory, most transactions would have a symmetrical result. However, the project staff recognizes that the influence of judgments and estimates in measurement, in addition to different standards on each side of the transaction (such as contingencies, where a loss is often recognized by one party before the gain is recognized by the other), make perfect symmetry difficult to achieve.

The FASB and the IASB considered symmetry between lessee and lessor to be important in developing its revised ED, especially in situations involving subleases, when an entity is both lessee and lessor with respect to the same underlying asset. Feedback received prior to the revised ED indicated that constituents desired symmetry.

BC9. The main feedback received on the proposals included in the 2010 Exposure Draft was as follows:

\* \* \* \* \*

- c. Many respondents disagreed with the lessor accounting proposals:
  - 1. Some were concerned that the dual accounting model proposed for lessors was not consistent with the single accounting model proposed for lessees.

However, feedback received on the revised ED has indicated that symmetry may not be as important to stakeholders as it once was. Some of these constituents acknowledged that they changed their minds on the symmetry issue after seeing the proposed changes to lessor accounting, with particular disagreement about changes for leases of property.

Feedback from the GASB's Leases task force during the meeting with the Board in January indicated that members think symmetry between lessee and lessor accounting is important in the governmental environment. In addition to subleases, there are many leases within a reporting entity, such as between a primary government and a component unit. Symmetry in accounting for these transactions may help prevent distortion of the total government's financial position. The project staff notes that some component units do not follow GASB standards (such as a university's not-for-profit foundation that follows FASB standards). However, providing symmetry for the many cases when both the lessee and lessor within the reporting entity follow the same standards may still be a desirable goal.

### **Arguments against Symmetry**

Perfect symmetry between lessee and lessor accounting may not be possible. For example, existing standards related to revenue recognition and the realizability of receivables would need to be considered. While the FASB and IASB considered symmetry to be important in developing their revised ED, it is noted that the proposals

do not result in perfect symmetry. Most significantly, Type B leases would result in the lessee recognizing a liability but the lessor not recognizing a corresponding receivable. This is an indication that other concerns may outweigh the desire for symmetry. There were several reasons given for this asymmetrical proposal, including cost-benefit concerns.

BC73. However, the Boards decided not to propose the recognition of a lease receivable and derecognition of a portion of the underlying asset for all leases and, in particular, not for most property leases, for a number of reasons:

- a. When the lessee is expected to consume very little, if any, of the economic benefits embedded in the underlying asset, the right-of-use asset transferred to the lessee does not represent the sale of any significant portion of the underlying asset (as described in paragraphs BC43–BC47). The lessor “loans” the underlying asset to the lessee, allowing the lessee to use its asset during the lease term, subject to market constraints, and charges the lessee for that use on the basis of a desired return on its investment in the asset. The lessee then returns the asset to the lessor in virtually the same condition as it was at the commencement date. In that circumstance, the economic benefits embedded in the underlying asset are not expected to change to any real extent over the lease term because the lessor is expected to get back virtually the same asset that it gave up at the commencement date. Accordingly, the Boards have concluded that when there is little or no consumption of the underlying asset (that is, when the economic benefits embedded in the underlying asset are not expected to change significantly over the lease term), more useful information would be provided by continuing to recognize the underlying asset rather than by recognizing a lease receivable and a residual asset, which would result in accounting for the lease as the sale of a portion of the underlying asset. A lessor would reflect better the economics of the transaction by recognizing rental income over the lease term.
- b. Discussions with lessors indicate that there are two different lessor business models:
  1. The leasing activities of some lessors are primarily about providing finance to lessees. Such lessors would typically have no ongoing involvement with the underlying asset while it is the subject of a lease or, if they do, that involvement is priced separately from the lease. Most equipment and vehicle lessors

- tend to have such a business model. The Boards concluded that accounting for a lease as the sale of a portion of the underlying asset with financing would appropriately reflect such a lessor's business model.
2. Other lessors manage the underlying asset throughout the lease term and over the economic life of the asset. In those lessors' views, they are not primarily in the business of providing finance to lessees. Instead, their aim is to generate cash flows from the underlying asset on an ongoing basis by managing the asset over a period typically longer than any one lease term. Most property lessors tend to have such a business model. The Boards concluded that accounting for a lease by recognizing the lease payments received as rental income over the lease term would appropriately reflect such a lessor's business model.
  - c. The underlying asset in most property leases meets the definition of investment property in IAS 40, *Investment Property*. Lessors of investment property applying IFRS must either measure their investment property at fair value or, if measured at cost, disclose the fair value of the investment property. Some users of financial statements have confirmed that the fair value of an entire investment property gives them more useful information than other measurements. Rental income and changes in fair value are inextricably linked as integral components of the performance of the lessor, and having both pieces of information (that is, rental income and fair value changes) results in a lessor reporting performance in a meaningful way. Consequently, the Boards concluded that the recognition of a lease receivable and a residual asset (measured on a cost basis) for each portion of an investment property leased to a different tenant would not provide more useful information for investment property than what is provided under existing requirements.
  - d. The approach would be extremely complicated to apply when one asset is leased to multiple parties concurrently. [underlining added for emphasis]

Additionally, as discussed in one FASB member's alternative view, it can be argued that there should not be symmetry between lessee and lessor accounting because of the different rights and obligations associated with each side of the transaction. Specifically, the lessor has a continuing interest in the residual asset. The Basis for Conclusions to the revised ED includes the following in his alternative view:

BC357.b. Lessor accounting under the proposed requirements is determined by applying the lessee model symmetrically to lessors without considering differences in the substance of rights and/or obligations under the lease contract associated with the residual asset for lessees as compared to lessors. Each lease contract includes an obligation at the end of the lease term for the lessee to return the underlying asset to the lessor and the symmetric right of the lessor to get the underlying asset back from the lessee. The proposed requirements for the lessee view the obligation to return the underlying asset to the lessor at the end of the lease term as nonsubstantive, merely requiring the lessee to return an asset that it never had the right to under the lease contract. The transfer to the lessor, therefore, does not involve transfer of economic resources controlled by the lessee and does not increase the value of the lessee's lease liability. In contrast, the underlying asset being returned to the lessor does have economic value to the lessor because it involves the return of the underlying asset that the lessor owns and the lessor can either subsequently re-lease or otherwise use for future economic return. The right to the return of the underlying asset to the lessor, therefore, is substantive having direct bearing on whether the lease transaction is economically beneficial to the lessor. Reobtaining a residual asset that is worth either less or more than anticipated at lease inception can make the lessor's return on the lease contract either negative or more positive, respectively. Thus, the economic benefits to the lessee and lessor associated with rights and obligations under a lease contract are not symmetric because the lessor's economic return is affected by its continuing involvement with the full underlying asset (including the residual asset), while the lessee's benefits under the lease are limited only to benefits it receives from using a portion of the lessor's underlying asset over the lease term. [This FASB member] believes that difference should cause differences in the accounting required for lessees and lessors, as is discussed below.

\* \* \* \* \*

BC359. Second, he believes the accounting for lessees and lessors should be asymmetric, reflecting the differences in the substance of the rights and/or obligations in the lease contact associated with the residual asset for lessors as compared to lessees....Rather, he suggests that to maximize the decision usefulness of the information for users and to minimize reporting complexity, the Boards should prescribe a single (but asymmetric) lease model for both lessees and lessors and provide additional disclosures in one location that permit users to make the adjustments necessary to fit their decision models.

### **Project Staff Analysis**

The project staff notes that feedback received from the GASB's stakeholders has favored symmetry between lessee and lessor accounting. The project staff also acknowledges that perfect symmetry may not be possible. However, the project staff believes that symmetry, from the standpoint that both governmental parties involved in the lease view it as a financing, should be a key factor as the Board develops a lessor accounting model.

### **Board Discussion Question**

#### **Question 2**

**Should the notion of having symmetry between lessee and lessor accounting be a key factor in development of a lessor accounting model?**

The project staff recommends that symmetry between lessee and lessor accounting should be a key factor in development of a lessor accounting model.

## FEDERAL LESSOR EXAMPLES

Tab A -- Attachment III-B

FEDERAL ENTITY/LESSOR	LEASED ASSET	LESSEE TYPE	LEASE TERM
NASA	Building - Airfield	Educational Institution	3.5 years
NASA	Building - Airfield	Educational Institution	5 years
NASA	Fuel Farm Offices - Airfield	Private Entity	5 years
NASA	Land - Airfield	State & Local Government	20 years
NASA	Land Parcels - Research Ctr	State & Local Government	until 9999
NASA	Land - Space Center	State & Local Government	30 years
NASA	Test Facility	Private Entity	until 9999
NASA	Land - Space Center	Federal Entity	until 9999
Treasury - OCC	Office Building w/ Parking	Federal Entity	20 yrs w/ renewals
Commerce - NOAA	Marine Station	Federal Entity	5 years
Commerce - NOAA	Land - Marine Research Ctr	Educational Institution	20 years
Commerce - NOAA	Parking Lot - Science Ctr	Private Entity	25 years
Commerce - NOAA	Land	Educational Institution	20 yrs w/ renewals
Transportation	Office Space	Federal Entity	1 year