



December 5, 2013

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 E-1**¹

MEETING OBJECTIVE

To review the results of the FASAB staff 2012 Lease questionnaire.

BRIEFING MATERIAL

- Staff Memo
 - Summary of Questionnaire Responses with Staff Analysis and Recommendations
- Attachment I
 - Quick Table of Questionnaire Respondents and Answers
- Appendix A
 - *OMB Circular No. A-11: Preparation, Submission, and Execution of the Budget – Appendix B—Budgetary Treatment of Lease-Purchases and Leases of Capital Assets*

Background

On January 17, 2012, staff circulated a questionnaire to the federal CFO community to gather information on the various leasing activities of federal entities.

Staff has also reviewed the 2012 annual financial statements of the 23 federal entities that responded to the questionnaire to gain additional information on their leasing activities. In addition, staff has followed up with some of the entities to get clarification on certain responses.

¹ 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.

Number of Responses Received

As of the date of this memo, 23 responses to the questionnaire have been received, representing CFO offices. Responses were received from the following federal entities:

Abbreviation	Full Name
CFTC	Commodity Futures Trading Commission
DHS	Department of Homeland Security
DOC	Department of Commerce
DOD	Department of Defense
DOE	Department of Energy
DOEd	Department of Education
DOI	Department of the Interior
DOJ	Department of Justice
DOL	Department of Labor
DOT	Department of Transportation
EPA	Environmental Protection Agency
GSA	General Services Administration
HHS	Department of Health and Human Services
HUD	Department of Housing and Urban Development
NASA	National Aeronautics and Space Administration
NRC	Nuclear Regulatory Commission
NSF	National Science Foundation
OPM	Office of Personnel Management
SEC	Securities and Exchange Commission
SSA	Social Security Administration
TREAS	Department of the Treasury
USDA	U.S. Department of Agriculture
VA	Department of Veterans Affairs

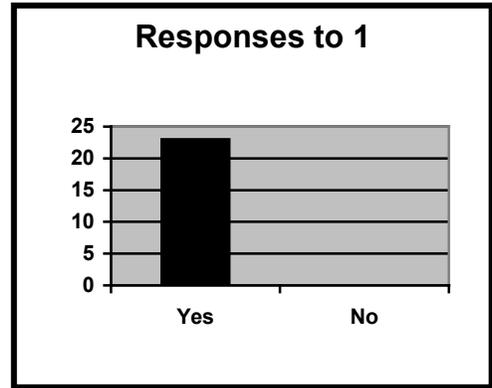
Summary of Responses Received

The questions are presented below along with a summary of the responses received. Please refer to *Attachment 1* for a more detailed look at the specific responses to each question. The staff's summary is intended to support your consideration of the questionnaire responses and does not fully capture all of the comments contained within the individual responses.

Question 1

Does your federal agency/entity engage in any leasing activities? If Yes, please provide a brief summary of the leasing activities.

23 Yes
0 No



Staff analysis:

All of the 23 respondents confirmed that they engage in leasing activities. About half of the entities noted that they have occupancy agreements with GSA. Based on the comments received to question 1, it is apparent that leasing activities are prevalent throughout the federal government.

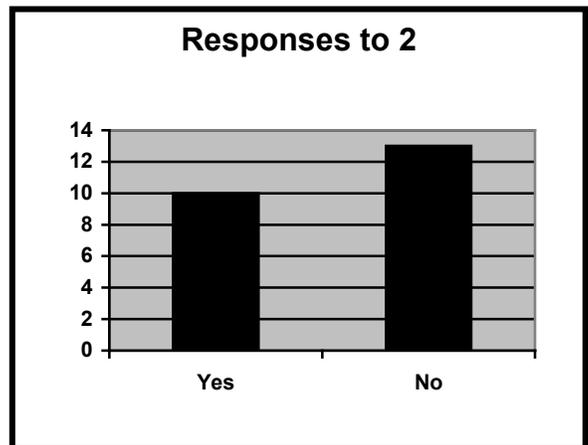
Staff recommendation:

Given that all of the respondents engage in leasing activities, staff recommends that the FASAB lease accounting project continue.

Question 2

Does your federal agency/entity consider your leasing activities to be material (i.e., lease dollar value or number of leasing contracts)? If Yes, please provide a basis for your materiality determination.

10 Yes
13 No



Staff analysis:

Less than half of the 23 respondents consider their leasing activities to be material.

Staff recommendation:

Even though 10 out of 23 respondents consider their leasing activities to be material, staff recommends that the FASAB lease accounting project continue.

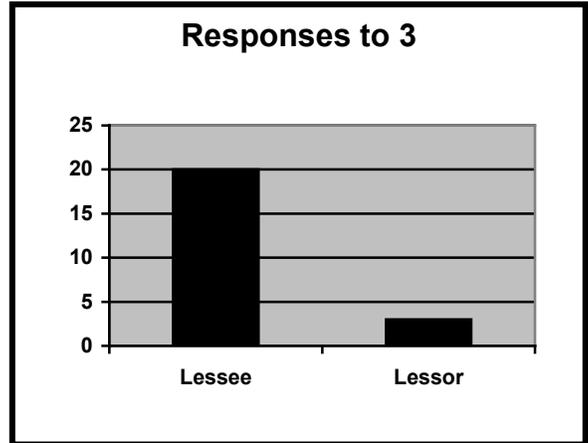
Question 3

Does your federal agency/entity more often serve as the lessor (asset owner) or the lessee (leases/uses asset)? Please provide a percentage breakdown of lessor vs. lessee activities.

20 Lessee
3 Lessor

Staff analysis:

A majority of the respondents indicated that they are primarily the lessee in their leasing activities. Only GSA, NASA and DoD-US Army Corp of Engineers (USACE) noted substantial lessor activities.



Staff recommendation:

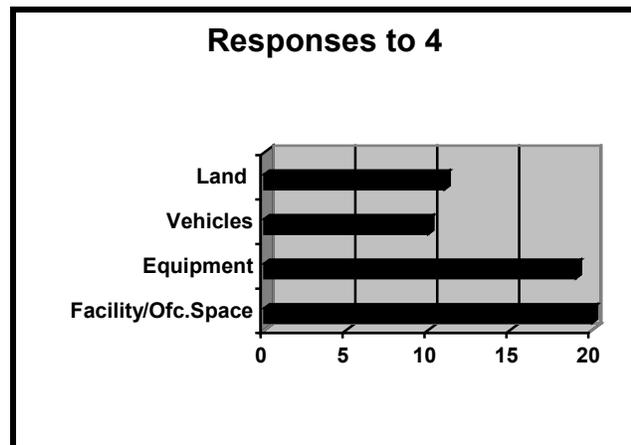
Even though most federal entities serve as the lessee, staff recommends that FASAB develop lease accounting standards for both lessees and lessors.

Question 4

What types/categories of leased assets (i.e., buildings, facilities, vehicles, land, equipment, software, etc.) are associated with your federal agency/entity's leasing activities?

Some of the specific lease items that entities noted in the questionnaire responses are noted below:

- Information technology equipment
- Telecommunication equipment
- Buildings
- Vehicles
- Software licenses
- Facilities
- Land
- Office space
- Laboratory space
- Warehouse/garage/storage space
- Rooftops (for antennas)
- Office equipment
- Furniture
- Trailers
- Hangers
- Aircraft
- Ships
- Parking space
- Fiber cable
- Firefighting equipment
- Machinery



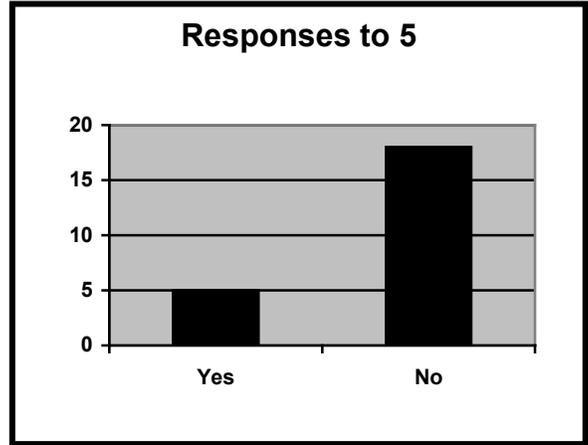
Staff analysis:

Staff will work with the Board and task force to ensure that revised lease accounting standards are applicable to varying types of leased items.

Question 5

Is your federal agency/entity involved in any enhanced use leases² (EUL)? If Yes, please provide a brief overview of those EUL activities.

5 Yes
18 No



Staff analysis:

Although only 5 of the 23 respondents currently have EUL authority, DoE noted that they have requested EUL authority twice but has not been granted the authority at this time. The five federal entities currently with EUL authority are VA, GSA, DoD-USACE, USDA, and NASA.

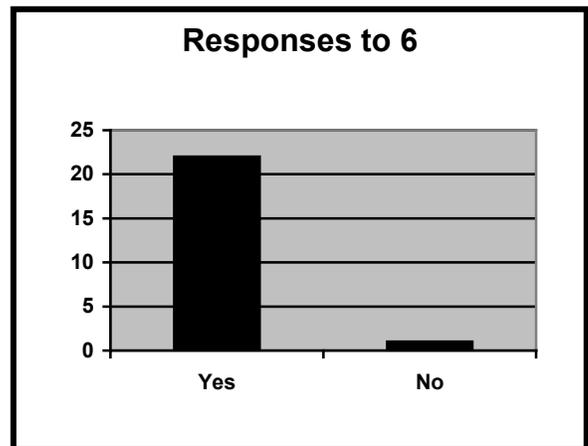
Staff recommendation:

Even though only 5 out of 23 respondents currently have EUL authority, there is the possibility that additional entities may also be granted EUL authority in the future. Therefore staff recommends that EUL activities be addressed in the proposed lease accounting standards.

Question 6

Does your federal agency/entity currently use federal accounting guidance (i.e., SFFAS 5 & 6) to account for your leasing activities? If Not, what accounting guidance does your federal agency/entity follow.

22 Yes
1 No



² **Enhanced Use Lease** – Typically a long-term agreement with public and private entities for the use of federal property, resulting in cash and/or in-kind consideration for the agency—or to retain the proceeds from the sale of real property. (*Federal Real Property: Authorities and Actions Regarding Enhanced Use Leases and Sale of Unneeded Real Property* -- GAO-09-283R, 02/17/2009)

Staff analysis:

CFTC noted that they do not follow FASAB standards but follow FASB codifications. Staff did note that many entities stated that they look to the FASB codifications for lease accounting topics not addressed in SFFAS 5 and 6.

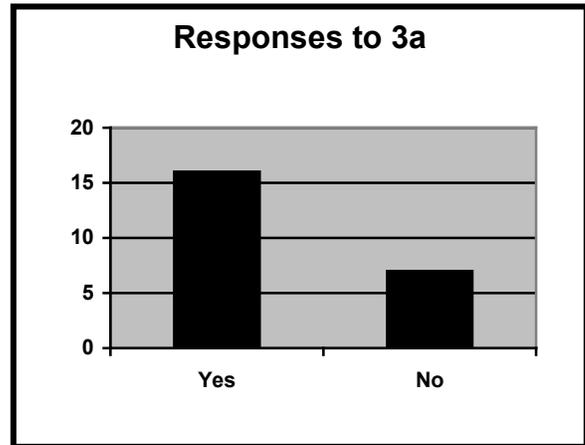
Staff recommendation:

Staff recommends that the revised lease accounting standards be comprehensive in order to fully address the topics needed in the federal environment.

Question 7

Does your federal agency/entity find the current federal lease accounting guidance adequate for your purposes or is it lacking certain areas?

16 Yes
7 No



Staff analysis:

The following federal entities responded no to the adequacy of the current federal lease accounting guidance – CFTC, DHS, GSA, NASA, SEC, Treasury, and USDA. The following comments were submitted by the seven entities who responded no to Question 7.

Clearer guidance is needed in the following areas:

- Construction in process of a leasehold improvement – when to capitalize (i.e., date construction is completed, date of acceptance of the work, etc.)
- Deferred lease asset/liability — when to recognize and how to amortize
- GSA occupancy agreements – are they leases
- Cancelable vs. non-cancelable lease
- Lease commencement
- Establishing the leases terms when options are available
- Defining the estimated economic life of a leased item
- Capitalization thresholds for leased items
- Leases between federal entities
- Leasehold improvements
- Rent abatements and rent holidays
- Free rent periods and credits towards space alterations
- Sub-leasing arrangements when GSA is the lessee and lessor
- Leases related to portions of a leased item
- Sales-type leases, leveraged leases, direct financing leases, and sale-leasebacks
- Scheduled rent increases

While the majority of respondents agreed that they find the current federal lease accounting standard adequate, the following suggestions for improving the guidance were submitted for consideration:

- More examples/implementation guidance would be helpful
- More comprehensive guidance would be helpful
- Guidance on leases with cancellation penalties
- Definitions for lease terminology

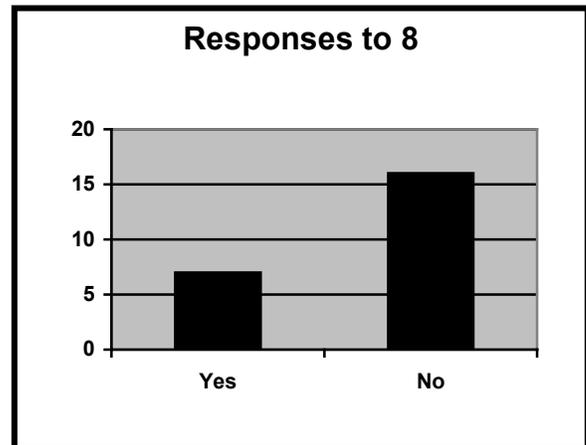
Staff recommendation:

Given the extensive list of lease accounting areas needing guidance, staff stresses the need for comprehensive lease accounting standards to fully address the topics needed in the federal environment.

Question 8

Does your federal agency/entity have other concerns with the current federal lease accounting guidance? If Yes, please explain your concerns.

7 Yes
16 No



Staff analysis:

The following federal entities responded yes to the question of other concerns with the current federal lease accounting guidance – CFTC, NSF, GSA, DoE, SEC, EPA, and USDA. The following comments were submitted by the seven entities who responded yes to Question 8.

Concerns were noted in the following areas:

- Need guidance on leases with service components
- Need guidance on software licenses
- Consistency between lessor and lessee accounting
- Private sector lease standards serve different objectives than those in the public sector
- Need guidance when third-party financing is involved
- Leases held by contractors
- Assignable leases

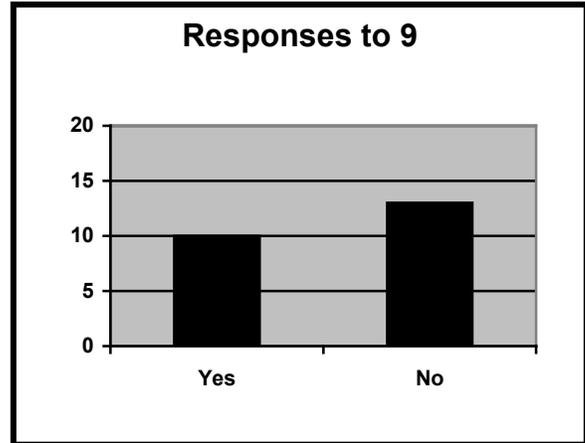
Staff recommendation:

Staff reiterates the need for comprehensive lease accounting standards

Question 9

Does your federal agency/entity have any specific concerns with the current federal lease accounting standards (i.e., SFFAS 5 & 6) as it relates to the budget scoring of leases as outlined in Appendix B of OMB Circular A-11? If Yes, please explain your concerns.

10 Yes
13 No



Staff analysis:

About half of the respondents have concerns with the current lease accounting standards as they relate to the budget scoring of leases in OMB A-11. The following are some of the comments noted by respondents to Question 9.

- The inconsistencies between the accounting treatments for budgetary and proprietary accounting lead to problems – commonality and consistency would be greatly desired.
- Certain leases are scored as capital leases using the OMB A-11 criteria but score as operating leases per the SFFAS 6 criteria, due to the economic useful life exception.
- A-11 has six criteria for determining if a lease is capital or operating and SFFAS 6 has 4 criteria.
- Under A-11 all amounts are material, whereas FASAB standards do not apply to immaterial amounts.
- A-11 states that the full obligation over the life of the lease must be obligated up front if the lease does not have a cancellation clause.

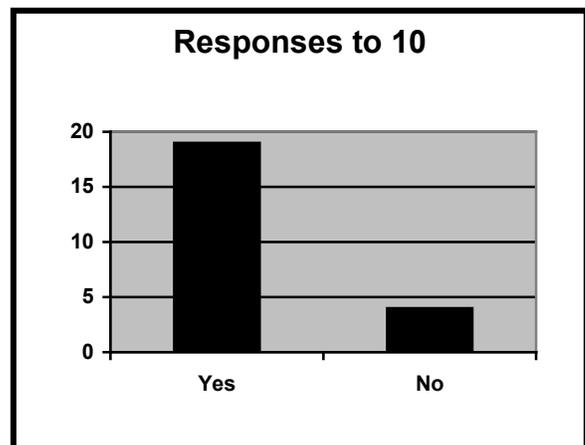
Staff recommendation:

Staff recommends that we work closely with OMB staff in developing the lease accounting standards to identify areas where consistency between the budget scoring of leases and the proprietary accounting for leases can be achieved.

Question 10

Would your federal agency/entity be interested in participating in a federal lease accounting task force sponsored by the FASAB?

19 Yes
4 No



Staff analysis:

Staff will ensure that the participants on the FASAB lease accounting task force are representative of the current federal leasing environment.

Conclusions

Given the responses from federal managers to staff's questionnaire on federal leasing activities, it appears that a majority of the concerns with the current federal guidance stem more from a lack of comprehensive guidance and inconsistencies with the budget scoring of leases.

The FASB model has been "criticized for failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leasing transactions." A similar criticism has been a concern in the federal environment as it relates to questions about the recognition of GSA occupancy agreements (i.e., are they leases, if so, should they be recognized as operating or capital leases?)

The following excerpt is from a recent GAO report, *Federal Real Property: Greater Transparency and Strategic Focus Needed for High-Value GSA Leases* (GAO-13-744, Sep 19, 2013):

Second, while the [budget] scoring analysis may allow the government to ensure that lease payments over the lease term are less than the fair market value of the asset, and thus that ownership of the asset stays with the lessor over the course of the lease, it does not help decision makers evaluate whether leasing is the preferred solution to an agency's space need. The scoring analysis is based on the lease term, not on the projected length of the government's space need. GSA officials stated that, given its limited access to capital funds, GSA works to ensure that all of its leases score as operating leases, because, as explained previously, for operating leases, only the amount needed to cover the minimum rent payment for 1 year must be scored against GSA's fiscal year budget authority. For a lease to score as an operating lease, the present value of cumulative minimum lease payments over the lease term must be no more than 90 percent of the fair market value of the asset. [FN 31: To perform this scoring analysis, GSA uses established criteria to determine the fair market value of the asset at the inception of the lease and then compares this amount to annual lease payments multiplied by the number of years in the lease term.]

According to GSA officials, there are cases in which GSA has negotiated a shorter term—such as 5 or 10 years—for a high-value lease for operational flexibility, such as when GSA is working on renovating federal space that it plans to move the personnel occupying the lease into when the renovations are complete. However, GSA officials stated that at times, GSA has had to negotiate shorter lease terms primarily because that will ensure that the lease will score as an operating lease—regardless of how long the agency expects to need the space. As a result, while the lease term established represents the legal responsibility of the government to pay for the lease, it may not reflect the length of the need for the space or therefore the true cost of long-term leasing. Furthermore, some GSA and private sector officials stated that, at times, limiting the length of a lease term to ensure that the lease will score as an operating lease can be costly. For example, because lessors prefer the certainty of a long-term lease, they may be willing to negotiate lower annual payments for longer terms. In another example, in cases when the commercial real estate market is struggling, GSA may not be able to take advantage of economic conditions by locking in a low annual rent for as long as possible.

Given the concerns expressed in the questionnaire staff believes that changes to the current lease accounting model are necessary to ensure that the true substance of the federal government's leasing transactions are adequately reported.

➤ **Next Steps:**

Staff is planning to meet with the task force in January 2014 to discuss the following topics:

- Scope, definition, and inherent characteristics of leases
- Types of lease transactions prevalent in the federal government
- Lease classification vs. budget scoring of leases
- Lease vs. purchase considerations
- Views on current FASB/IASB proposal

Quick Table of Questionnaire Respondents and Answers

Agency	Question 1 - Does your federal agency/entity engage in any leasing activities?	Question 2 - Does your federal agency/entity consider your leasing activities to be material (i.e., lease dollar value or number of leasing contracts)?	Question 3 - Does your federal agency/entity more often serve as the lessor (asset owner) or the lessee (leases/uses asset)?	Question 4 - What types/categories of leased assets (i.e., buildings, facilities, vehicles, land, equipment, software, etc.) are associated with your federal agency/entity's leasing activities?	Question 5 - Is your federal agency/entity involved in any enhanced use leases (EUL)?
CFTC	Yes	Yes	Lessee	See list of types	No
DOC	Yes	Yes	Lessee	See list of types	No
DOD	Yes	No	Lessor and Lessee	See list of types	Yes
DHS	Yes	Yes	Lessee	See list of types	No
DOEd	Yes	No	Lessee	See list of types	No
DOE	Yes	No	Lessee	See list of types	No
EPA	Yes	No	Lessee	See list of types	No
GSA	Yes	Yes	Lessor and Lessee	See list of types	Yes
HHS	Yes	Yes	Lessee	See list of types	No
HUD	Yes	No	Lessee	See list of types	No
DOI	Yes	No	Lessee	See list of types	No
DOJ	Yes	No	Lessee	See list of types	No
DOL	Yes	Yes	Lessee	See list of types	No
NASA	Yes	No	Lessor and Lessee	See list of types	Yes
NRC	Yes	Yes	Lessee	See list of types	No
NSF	Yes	No	Lessee	See list of types	No
OPM	Yes	No	Lessee	See list of types	No
SEC	Yes	Yes	Lessee	See list of types	No
SSA	Yes	No	Lessee	See list of types	No
DOT	Yes	No	Lessee	See list of types	No
TREASURY	Yes	Yes	Lessee	See list of types	No
USDA	Yes	No	Lessee	See list of types	Yes
VA	Yes	Yes	Lessee	See list of types	Yes

Quick Table of Questionnaire Respondents and Answers

Agency	Question 6 - Does your federal agency/entity currently use federal accounting guidance (i.e., SFFAS 5 & 6) to account for your leasing activities?	Question 7 - Does your federal agency/entity find the current federal lease accounting guidance adequate for your purposes or is it lacking certain areas?	Question 8 - Does your federal agency/entity have other concerns with the current federal lease accounting guidance?	Question 9 - Does your federal agency/entity have any specific concerns with the current federal lease accounting standards (i.e., SFFAS 5 & 6) as it relates to the budget scoring of leases as outlined in Appendix B of OMB Circular A-11?	Question 10 - Would your federal agency/entity be interested in participating in a federal lease accounting task force sponsored by the FASAB?
CFTC	No	No	Yes	Yes	Yes
DOC	Yes	Yes	No	Yes	Yes
DOD	Yes	Yes	No	No	Yes
DHS	Yes	No	No	Yes	Yes
DOEd	Yes	Yes	No	No	Yes
DOE	Yes	Yes	Yes	Yes	Yes
EPA	Yes	Yes	Yes	No	Yes
GSA	Yes	No	Yes	Yes	Yes
HHS	Yes	Yes	No	No	Yes
HUD	Yes	Yes	No	No	Yes
DOI	Yes	Yes	No	No	Yes
DOJ	Yes	Yes	No	No	Yes
DOL	Yes	Yes	No	No	Yes
NASA	Yes	No	No	Yes	Yes
NRC	Yes	Yes	No	No	Yes
NSF	Yes	Yes	Yes	No	No
OPM	Yes	Yes	No	No	No
SEC	Yes	No	Yes	Yes	Yes
SSA	Yes	Yes	No	No	No
DOT	Yes	Yes	No	No	No
TREASURY	Yes	No	No	Yes	Yes
USDA	Yes	No	Yes	Yes	Yes
VA	Yes	Yes	No	Yes	Yes

TAB E-1

APPENDIX A

*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)

APPENDIX B—BUDGETARY TREATMENT OF LEASE-PURCHASES AND LEASES OF CAPITAL ASSETS

This Appendix provides instructions on the budgetary treatment of lease-purchases and leases of capital assets consistent with the scorekeeping rule developed by the executive and legislative branches originally in connection with the Budget Enforcement Act of 1990 (BEA) (see [Appendix A](#)). The scorekeeping rule focuses on leases and lease-purchases specifically authorized by law. However, these requirements apply to all lease-purchase arrangements and capital leases, including those arrangements that agencies may enter into under existing general legal authorities and arrangements that are financed through the Federal Financing Bank, except as noted below.

These requirements do not apply to leases between Federal agencies if the lessor recorded the full cost of the asset when it was acquired. In addition, the costs of Energy Savings Performance Contracts may be scored on an annual basis, consistent with the guidance provided in [OMB Memorandum 98-13](#), *Federal Use of Energy Savings Performance Contracting* and OMB Memorandum [M-12-21](#), *Addendum to OMB Memorandum M-98-13 on Federal Use of Energy Savings Performance Contracts and Utility Energy Service Contracts*.

Agencies are required to submit to their OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact:

- Any proposed lease of a capital asset where total Government payments over the full term of the lease would exceed **\$50 million**. It should be assumed that options to renew will be exercised.
- All financing proposals that are non-routine in nature and involve unique or unusual concepts or characteristics such as those listed below:
 - ▶ Outlease-leaseback mechanisms;
 - ▶ Establishment of public-private partnerships or limited liability corporations;
 - ▶ Issuance of debt by a third party that includes an explicit "full faith and credit" guarantee of debt repayment by the Government or an implicit guarantee of repayment from Federal funds that removes a substantial amount of the investor's risk;
 - ▶ Special purpose assets for which there is no real private sector market;
 - ▶ Enhanced-use leases with leasebacks with annual payments above the following threshold levels:
 - ▶ 2013—\$2,790,000
 - ▶ 2014—\$2,850,000
 - ▶ 2015—\$2,850,000
 - ▶ Projects constructed or located on Government land;
 - ▶ Contracts that require the contractor to acquire or construct assets valued over \$50 million;
 - ▶ Share in savings proposals that result in the acquisition of real property;
 - ▶ Proposals that raise issues about the governmental/non-governmental status of the asset or the entity that holds the title to the asset;

- ▶ Any financing proposal for which a statute requires OMB approval of the scoring (or of the proposal) or compliance with Circular No. A-11. Where compliance with Circular No. A-11 or other specified scoring rules is required by statute, the agency submission must be accompanied by a memorandum from the agency General Counsel explaining how the statutory criteria are satisfied;
- ▶ Arrangements that convey special tax status to the project by virtue of the Government's participation; and
- ▶ Leasing arrangements that involve options that can be conveyed to a third party in exchange for future considerations.

Agencies should submit these proposals to OMB during the conceptual, developmental stage. Subsequent changes that could substantially change the scope of the proposal or affect the scoring impact (e.g., change from an operating lease to a lease-purchase) must be resubmitted to OMB.

1. Basic requirements

(a) *General.*

When an agency is authorized to enter into a *lease-purchase* or *capital lease* contract, budget authority will be scored in the year in which the authority is first made available in the amount of the net present value of the Government's total estimated legal obligations over the life of the contract, as described in section 2(b) below. Outlays for lease-purchases in which the Federal Government assumes substantial risk will be spread across the period during which the contractor constructs, manufactures, or purchases the asset. Outlays for a capital lease or a lease-purchase in which the private sector retains substantial risk will be spread across the lease term. The scorekeeping requirements are summarized below.

For *operating leases*, budget authority is required to be obligated up front in the amount necessary to cover the Government's legal obligations, consistent with the requirements of the Antideficiency Act. This will include the estimated total payments expected to arise under the full term of the contract or, if the contract includes a cancellation clause, an amount sufficient to cover the lease payments for the first year plus an amount sufficient to cover the costs associated with cancellation of the contract. For each subsequent year, sufficient budget authority is required to be obligated to cover the annual lease payment for that year plus any additional cancellation costs. For operating leases funded by the General Services Administration's Federal Buildings Fund (which is self-insuring under existing authority), only the amount of budget authority needed to cover the annual lease payment is required to be obligated.

(b) *Making annual lease payments after the BA expires.*

Unless otherwise specified by law, budget authority is available for liquidating obligations (i.e., outlays) for only five fiscal years after the authority expires. For leases financed by annual or multi-year budget authority, agencies should ensure that the appropriations language allows the budget authority to remain available for lease payments over the full term of the lease. If this period is expected to be longer than five fiscal years after the authority expires, the appropriations language should include the provision described in section [95.7](#).

(c) *Changes to existing contracts.*

When an agency modifies or amends an existing capital lease or lease-purchase contract, any remaining budgetary resources prior to modification should be used to offset the cost of the new contract. The amount scored will be the difference in the net present value of the Government's total estimated legal obligations between the new contract and the remaining term of the original contract. (Both net present

values should be calculated using the Treasury borrowing rates published in the annual update to [Appendix C of OMB Circular No. A-94](#) at the time the contract is amended (see section 4)). There would be no remaining budgetary resources if funds equal to the lease payments or the present value of the lease payments were not scored up front at the time the lease was signed. In this case, the full cost of the new contract should be scored, consistent with the rules for scoring lease-purchases and capital leases. Similarly, when an agency modifies or amends an existing operating lease contract, the impact of the changes needs to be evaluated. If the lease no longer meets the criteria for an operating lease, the modified lease should be rescored.

(d) *Options to renew or purchase.*

When the lease agreement contains an option to renew that can be exercised without additional legislation, it will be presumed that the option will be exercised for purposes of calculating the term of the lease and scoring budget authority. When the lease agreement contains an option to purchase at less than fair market value (at the time the option is to be exercised), and the option can be exercised without additional legislation, it will be presumed that the option will be exercised for purposes of classifying the type of lease and scoring budget authority.

SUMMARY OF BUDGET REQUIREMENTS

Transaction	Budget Authority	Outlays
Lease-purchase without substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease period.	Amount equal to asset cost scored over the construction period in proportion to the distribution of the contractor's costs; amount equal to imputed interest costs recorded on an annual basis over lease term.
Lease-purchase with substantial private risk	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Capital lease	Amount equal to asset cost recorded up front; amount equal to imputed interest costs recorded on an annual basis over lease term.	Scored over lease term in an amount equal to the annual lease payments.
Operating lease	Amount equal to total payments under the full term of the lease or amount sufficient to cover first year lease payments plus cancellation costs recorded up front	Scored over lease term in an amount equal to the annual lease payments.

2. Budget presentation

(a) *General.*

For the purposes of scorekeeping transactions that involve lease-purchases and capital leases, the costs are separated into the following components:

- Asset cost (which equals the present value of the lease payments); and

- Imputed interest cost (which equals the financing cost Treasury would have incurred if it had financed the project by borrowing).

These concepts are defined more fully in section 3. The amounts can be determined from the amortization tables developed in accordance with the instructions in section 4. Budget authority and outlays attributable to asset costs will be classified as investment-type activities (physical assets), and budget authority and outlays attributable to imputed interest costs will be classified as non-investment activities (see section [84.4](#)).

(b) *Budget authority.*

- *Amounts.* The up-front budget authority required for both lease-purchases and capital leases is called the asset cost. This equals the present value of the minimum lease payments excluding payments for identifiable annual operating expenses that would be paid by the Government as owner, such as utilities, maintenance, and insurance. Property taxes will not be considered to be an operating expense and will be included in the calculation of the up-front budget authority. (See section 3 for the treatment of property taxes for purposes of distinguishing operating leases from capital leases.) The present value of the lease payments is discounted as of the date of the first payment (or the beginning of the lease term, whichever is earlier) using the appropriate interest rate (see section 4 for a more detailed explanation and the treatment of multiple deliveries).

Additional budget authority equal to Treasury's cost of financing (i.e., the imputed interest cost) plus any annual operating expenses will be recorded on an annual basis over the lease term.

- *Type of authority.* When an agency enters into a capital lease or lease-purchase under general authorities available to the agency, it must do so within the limits of the budgetary resources available to it and the constraints of the scorekeeping requirements.

If Congress enacts legislation that enables an agency to enter into a lease-purchase or capital lease for a specific project without further congressional action (e.g., appropriations action), it will be assumed that Congress has provided the budget authority required for the transaction. If Congress does not provide the budget authority in the form of an appropriation, then authority to borrow or contract authority will be recorded as follows:

- ▶ *Authority to borrow* will be recorded if the transaction is a lease-purchase without substantial private risk, in which case outlays need to be scored up-front in advance of appropriations for the annual lease payment (or offsetting collections). A portion of the amount subsequently appropriated (or collected, if the agency receives offsetting collections) will be applied to retire outstanding agency debt attributable to the lease-purchase. (See sections 2(c) and 2(d) for more information on how that portion is determined and presented in the Budget.)
- ▶ *Contract authority* will be recorded if the transaction is a lease-purchase with substantial private risk or a capital lease, in which case outlays will be scored over the lease term and financed by appropriations for the annual lease payment (or offsetting collections). A portion of the amount appropriated (or collected, if the agency receives offsetting collections) will be applied to liquidate contract authority. (See sections 2(c) and 2(d) for more information on how that portion is determined and presented in the Budget.)
- *Timing.* When Congress enacts legislation that specifically enables an agency to enter into a lease-purchase or capital lease, the budget authority required for the transaction will be recorded when the authority first becomes available for obligation. Obligations will be recorded when the lease agreement is signed. When the authority stems from general authority available to the agency, obligations are recorded, and sufficient budgetary resources must be available, when the lease agreement is signed.

(c) *Outlays.*

- *Lease-purchases without substantial private risk.* Outlays are not equal to the annual lease payments.
 - ▶ Outlays are scored over the period during which the contractor constructs, manufactures, or purchases the asset, in an amount equal to the asset cost. This amount will equal the up-front budget authority. Amounts of the asset cost in excess of the contractor's actual construction or manufacturing costs should be distributed in proportion to the distribution of the construction or manufacturing costs. If the asset already exists, the outlays will be recorded in the year in which the lease-purchase contract is signed.
 - ▶ Outlays equal to the imputed interest costs are reported on an annual basis over the lease term.
- *Lease-purchases with substantial private risk and capital leases.* Outlays are scored annually equal to the annual lease payments.
 - ▶ Over the life of the lease agreement, a portion of the outlays (equivalent to the asset cost) will come from the balances obligated when the lease agreement was signed, and a portion (equivalent to the imputed interest cost) will come from new budget authority. The appropriate amounts can be determined from amortization tables developed in accordance with the instructions in section 4.

(d) *Annual appropriations for lease financed by contract authority or borrowing authority.*

Lease-purchases and capital leases that are financed by contract authority or borrowing authority will generally require annual appropriations in an amount equal to the annual lease payment. Since budget authority equal to the asset cost is scored up front, the portion of the annual appropriation that corresponds to the amortization of the asset cost is not scored as new budget authority. If it were, total budget authority would be overstated over the life of the lease. The budget authority that is recorded on an annual basis will equal the imputed interest cost. The required adjustments are explained below:

- *For lease-purchases without substantial private risk that are financed by borrowing authority.* An amount equal to the amortization of the asset cost component of the annual lease payment will be treated as redemption of debt and deducted from the new budget authority totals. On the program and financing schedule, this amount will be reported as a negative entry on line 1135 or 1236 (see section [82.18](#)). If offsetting collections are used to make the annual lease payment in lieu of an appropriation, the amount will be reported as a negative entry on line 1726 or 1825.
- *For capital leases and lease-purchases with substantial private risk that are financed by contract authority.* An amount equal to the amortization of the asset cost component of the annual lease payment will be treated as liquidating cash and deducted from the new budget authority totals. On the program and financing schedule, this amount will be reported as a negative entry on line 1137 or 1238 (see section [82.18](#)). (If offsetting collections are used to make the annual lease payment in lieu of an appropriation, the amount will be reported as a negative entry on line 1727 or 1826.)

(e) *Agency debt.*

For lease-purchases without substantial private risk, agency borrowing must be recorded to finance the outlays scored for the construction, manufacture, or purchase of the asset. The agency debt that accumulates over this period is equal to the asset cost; this debt is subsequently redeemed over the lease payment period in an amount equal to a portion of the annual lease payment. The appropriate amounts of debt and debt redemption can be determined from the amortization tables developed in accordance with

the instructions in section 4, Step 5. Interest on agency debt can be determined in accordance with Steps 3, 4, and 5.

If the account has a balance sheet, the amount of such agency debt should be included as a separate item (and separate from other agency debt) under liabilities and identified as having been incurred to finance lease-purchases. All other accounts should include the amount of agency debt in the narrative statement for the account that is published in the *Budget Appendix*.

3. Definitions and concepts

For the purposes of scoring lease-purchases and capital leases, the following definitions and concepts apply. Agencies should consult with OMB in cases where enhanced use leases and public-private partnerships are involved. Public-private partnerships should not be used solely or primarily as a vehicle for obtaining private financing of Federal construction or renovation projects. Such transactions should be used only when they are the least expensive method, in present value terms, to finance construction or repair. Agencies shall consult with OMB in cases where a contract requires a private contractor to construct or acquire a capital asset solely or primarily to provide the service to the Government to determine the appropriate treatment or obligations.

Lease-purchase means a type of lease in which ownership of the asset is transferred to the Government at or shortly after the end of the lease term. Such a lease may or may not contain a bargain-price purchase option.

Capital lease means any lease other than a lease-purchase that does not meet the criteria of an operating lease.

Operating lease means a lease that meets all the criteria listed below. If the criteria are not met, the lease will be considered to be a capital lease or a lease-purchase, as appropriate. Multi-year service contracts (e.g., grounds maintenance) and multi-year purchase contracts for expendable commodities (e.g., aspirin) are not considered to be operating leases.

- 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;
- The lease does not contain a bargain-price purchase option;
- The lease term does not exceed 75 percent of the estimated economic life of the asset;
- 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;
- 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
- There is a private sector market for the asset.

The following guidelines will be used in distinguishing between operating leases, capital leases, and lease purchases. They should be used in calculating the *term of the lease* and the value of the *minimum lease payments*:

- *Estimate of fair market value.* In the case of real property, the fair market value should be based on current market appraisals. If no asset exists, the fair market value of the proposed asset should be based on the Government's estimate of the private developer's cost to construct the leased

facility. The estimate should only include the costs the Government would normally pay the private sector for such a facility. These costs include the total direct and indirect costs of constructing the facility, including land purchase, design, site improvements, and management costs. Fair market value should not include the value of features or enhancements that were built or added for the Government's unique needs or special purposes or features or enhancements that will be paid for by the Government in lump sum. If the Government proposes to lease only a portion of a facility, then the estimate of fair market value should be adjusted accordingly to reflect the portion that will be leased by the Government.

- *Special features or enhancements.* Assets that have special features or enhancements that were built or added for the Government's unique needs or special purposes need to be evaluated on a case-by-case basis to ascertain whether they can be considered to be general purpose assets. If the asset is considered to be a general purpose asset, then, as a general rule, such special features or enhancements should be financed up-front, separate from the lease.
- *Upfront, lump sum payments.* If the terms of a lease contain an upfront, lump sum payment, only the amounts associated with special features or enhancements to meet the Government's unique needs or specifications and the amounts associated with agency specific customizations can be removed from the agency scoring calculation. Any payment in excess of that amount will be factored into the net present value scoring calculation. The rental stream over the life of the lease must be adequate to provide functional space.
- *Projects on Government land.* If the project is constructed or located on Government land, it will be presumed to be for a special purpose of the Government.
- *Renewal and purchase options.* If the lease agreement contains an option to renew that can be exercised without additional legislation, it will be presumed that the option will be exercised. If the lease agreement contains an option to purchase at less than fair market value (at the time the option is to be exercised), and the option can be exercised without additional legislation, it will be presumed that the option will be exercised.
- *Cancellation clauses.* It will be presumed that the lease will run for the full term of the contract, and the minimum lease payments will be calculated on the basis of the lease payments that will be made over the full term of the lease (including options to renew).
- *Lease-backs from public/private partnerships.* If an agency leases from a public/private partnership that has substantial private participation, the lease will be treated as a capital lease. The term "public/private partnership" includes special purpose entities for which the Government is a beneficiary. Substantial private participation means (1) the non-Federal partner has a majority ownership share of the partnership and its revenues; (2) the non-Federal partner has contributed at least 20 percent of the total value of the assets owned by the partnership; and (3) the Government has not provided indirect guarantees of the project, such as a rental guarantee or a requirement to pay higher rent if it reduces its use of space. Total value includes the value of assets contributed by the Government (but not the value of land) and all improvements made to the asset. Contributions by the non-Federal partner of cash, real assets, and loans for which the non-Federal partner is responsible for repayment will count towards meeting the 20 percent threshold. Direct loans from the Government or guarantees by the Government of loans made to the non-Federal partner or to the partnership will not count towards the 20 percent threshold.

If a public/private partnership fails to meet the test of substantial private participation, the partnership will be considered governmental for purposes of the budget, and the lease-back will be scored against the agency that enters into the partnership.

If the Government ground-leases property to a non-Federal party and subsequently leases back the improvements, the lease will not be considered a lease-back from a public/private partnership, as long as the lessor is a totally non-Federal entity. Such lease-backs may be treated as operating leases if they meet the criteria for an operating lease.

- *Bargain-price purchase option.* A bargain-price purchase option is a provision allowing the Government to purchase the leased property for a price that is lower than the expected fair market value of the property at the date the option can be exercised. The purchase price includes the value of any rebates or income to the agency or Government resulting from its purchase of the asset.
- *Property taxes.* Property taxes, along with other operating expenses, will be excluded from the lease payments for purposes of comparing the present value of the minimum lease payments with the fair market value of the asset. (Note: Property taxes will be included in the calculation of the net present value of the lease payments for purposes of scoring budget authority under the BBEDCA. See section 2(b) above.)
- *Interest rates.* The present value of the minimum lease payments will be calculated on the basis of Treasury rates for marketable debt instruments of similar maturity to the lease term (see section 4).

Risk means the level of private-sector risk. Lease-purchase agreements are scored as with or without substantial private risk depending on the level of private-sector risk. Substantial private risk means the absence of substantial government risk. Risk is defined in terms of how governmental in nature the project is. That is, if the project is less governmental in nature, the private sector risk is considered to be higher.

The following types of illustrative criteria indicate ways in which the project is *less governmental*:

- There is no provision of Government financing and no explicit Government guarantee of third-party financing;
- Risks incident to ownership of the asset (e.g., financial responsibility for destruction or loss of the asset) remain with the lessor unless the Government was at fault for such losses;
- 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;
- There is a private-sector market for the asset; or
- The project is not constructed on Government land.

Imputed interest cost means the financing costs that Treasury would have incurred if it had sold debt to the public equal to the total project cost. The difference between the total estimated legal obligations (excluding obligations for annual operating expenses as described in section 2(b)) and their estimated net present value represents imputed interest costs. Imputed interest costs will be calculated at Treasury rates for marketable debt instruments of similar maturity to the lease term on the date the contract is signed. These costs will be considered mandatory under the BBEDCA and will be shown in the same function as interest on agency debt, that is, in the function that provided the obligational authority to enter into the contract.

Differential cost of financing means the total annual interest payments on any debt sold to the public less the interest payments that would have been made on the same amount of debt at the Treasury rate (i.e.,

less the imputed interest costs). Simply stated, this corresponds to any interest above Treasury's interest rate.

Asset cost means the present value of the agency's minimum lease payments discounted from the date of the first payment (or the beginning of the lease term, whichever is earlier) using the Treasury interest rate for marketable debt instruments of similar maturity to the lease term on the date the contract is signed and excluding obligations for identifiable annual operating expenses as described in section 2(b). Asset cost corresponds to the total construction or acquisition costs, plus property taxes and any interest above Treasury's cost of financing (i.e., the differential cost of financing). See section 4 for more detailed explanation and the treatment of multiple deliveries.

4. Guidance on calculations

A schedule of lease payments or an amortization schedule is required to calculate budget authority, outlays, and debt for capital leases or lease-purchases. The correct Treasury rate to use for discounting to present value and for calculating imputed interest costs will be based on the economic assumptions in the most recent budget, which, for the current year, are published in the annual update to [Appendix C of OMB Circular No. A-94](#). Revised forecasts of these Treasury interest rates are released whenever economic assumptions for the budget are updated. Use Treasury rates for marketable debt instruments of similar maturity to the lease term on the date the contract is signed. Discount from the date of the first payment (or the beginning of the lease term, whichever is earlier). The term selected for the Treasury rate should be comparable to the term of the capital lease or lease-purchase.

All assumptions required to perform the lease analysis are subject to OMB approval.

Step 1—Calculate up-front BA.

For lease-purchase without substantial private risk; lease-purchase with substantial private risk; and capital lease (including lease-back from public/private partnership with substantial private sector participation): To determine up-front BA (i.e., asset cost), calculate the present value of the lease payments, discounting from the date of the first payment or the beginning of the lease term, whichever is earlier, using the appropriate Treasury interest rate as the discount factor and excluding obligations for identifiable annual operating expenses as described in section 2(b). This BA is scored when the authority to enter into a contract for the lease-purchase or capital lease first becomes available for obligation.

However, if the lease contract provides for multiple deliveries of assets, the up-front BA is sum of the present values of the lease payments for each asset discounted back to the date that the asset is delivered. For example, if the lease contract provides for the delivery of one machine in each of the next five years, the lease payments for the machine acquired in the first year would be discounted back to the first year, while the lease payments for the machine acquired in the fifth year would be discounted back to the fifth year, and the total BA recorded up front would be the sum of the present values calculated for each of the five deliveries.

Step 2—Calculate outlays over the period during which the contractor constructs, manufactures, or purchases the asset.

For lease-purchase without substantial private risk: Score outlays in proportion to the distribution of the contractor's costs. For example, assume a contractor's costs on a \$50 million project are estimated to be \$7.5 million the first year, \$27.5 million the second year, and \$15 million the third year. The analyst should apply spendout rates of 15 percent, 55 percent, and 30 percent to the BA calculated in Step 1 for the first, second, and third years, respectively. Total outlays at the end of the construction, manufacture, or purchase period should equal the BA calculated in Step 1. (Note that total outlays will ordinarily exceed the contractor's costs.)

For lease-purchase with substantial private risk and capital lease (including lease-back from public/private partnership with substantial private sector participation): Outlays are not scored during this period. Refer to Step 4 for outlay scoring.

Step 3—Calculate annual BA for the lease payment period.

For lease-purchase without substantial private risk; lease-purchase with substantial private risk; and capital lease: Annual BA will equal the imputed interest costs calculated using the same Treasury interest rate used to discount the lease payments in Step 1. The interest portion of each periodic payment is the imputed interest cost. In the case of a lease-purchase without substantial private risk, the interest rate should be applied to debt that is initially equal to the up-front BA calculated in Step 1 and that is then amortized over the lease term in accordance with Step 5.

Step 4—Calculate outlays over the lease payment period.

For lease-purchase without substantial private risk: Annual outlays are equal to the annual BA (i.e., the imputed interest costs).

For lease-purchase with substantial private risk and capital lease (including lease-back from public/private partnership with substantial private sector participation): Annual outlays are equal to the lease payments.

Step 5—Calculate agency debt (applies only to lease-purchases without substantial private risk).

Agency debt accumulates during the period of construction, manufacture, or purchase of the asset. The increase in debt each year equals the amount of outlays calculated in Step 2. Agency debt is subsequently redeemed over the lease payment period according to an amortization schedule. The amount of debt redemption each year is equal to the lease payment less the imputed interest cost as defined in Step 3. (Debt redemption is not scored as BA or outlays.) Imputed interest costs are scored as BA and outlays and are also scored as interest on agency debt.

5. Reporting to OMB and Treasury

Budget execution reports and apportionment requests will reflect budget amounts in accordance with these requirements. Amounts (e.g., budget authority and outlays) will be reported to Treasury on the same basis.



December 5, 2013

Memorandum

To: Members of the Board
M.R. Valentine

From: Monica R. Valentine, Assistant Director

Through: *Wendy M. Payne*
Wendy M. Payne, Executive Director

Subject: Leases Project – **Tab E-2**¹

MEETING OBJECTIVES

The objective of this session is to seek Board input concerning issues recently addressed by the GASB concerning *Leases*. Specifically, we will review the *characteristics inherent in leases* recently addressed by GASB and their potential application in the context of SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*.

BRIEFING MATERIAL

- Staff Memo
 - FASAB Staff Analysis and Board Questions on the Leases Project
- Attachments –
 - I – GASB September 2013 Staff Issue Paper on Lease Project
 - II – GASB Major Tentative Decisions on the Leases Project as of November 2013

BACKGROUND

The *Leases* project is being undertaken by the Board primarily because the current lease accounting guidance contained in SFFAS 5 and 6, has been criticized as being ineffective because the guidance does not make meaningful distinctions between

¹ 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.

capital and operating leases. That is, the substance of lease transactions is not adequately addressed by the guidance. In addition, the lease accounting standards in SFFAS 5 and 6 are based on Financial Accounting Standards Board (FASB) lease accounting standards which are currently being considered for revision. The FASB and International Accounting Standards Board (IASB) have undertaken a joint project on lease accounting that focuses on the conveyance of rights to future economic benefits (such as the right of use).

In May 2013 the FASB released a revised exposure draft (ED) on Leases. Since the release of the FASB ED, the Governmental Accounting Standards Board (GASB) has begun Board discussions to reexamine issues associated with lease accounting and consider improvements to existing guidance. FASAB staff is currently working with the GASB staff to coordinate our efforts where applicable, to develop new federal lease accounting guidance.

The objective of this session is to seek Board input concerning issues recently addressed by the GASB concerning the *characteristics inherent in leases* recently addressed by GASB and their potential application in the context of SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*.

Member feedback concerning these issues will assist staff in developing the next steps to take in the project.

**Staff Analysis and Questions for Board Consideration on the
FASAB Leases Project**

Note: Because the GASB issue papers are the basis for our analysis and questions, staff suggests reading the attached GASB issue paper (Attachment I) before considering the below FASAB staff analysis and Board questions.

GASB ISSUE 1², PAPER 1:

- ❖ **Characteristics Inherent in Leases – GASB Question 1:** *Does the Board believe there are inherently different types of leases? The GASB project staff believes the characteristics inherent in leases present compelling evidence that there is more than one type of leases for purposes of selecting the accounting treatment. Although the project staff recommended that the Board acknowledge that there are different types of leases, the GASB tentatively disagreed that there are different types of leases. Members believe all leases give rise to an asset and liability to be recognized and that governments primarily enter into leases to provide services. As a result, Members wanted to focus more on the specific problems with the current lease standards as it relates to state and local governmental entities.*

The GASB staff paper discusses various approaches to differentiating among leases resulting in different accounting treatments. These include the current approach (risk and rewards of ownership), the FASB/IASB proposal (consumption of economic benefits), and the approach proposed in the 2010 FASB exposure draft on leases. The chart on the next page provides an overview of the lessee accounting treatment aligned with these approaches.

Considering how the types of leases have translated into accounting treatments – current and proposed – may give you insights regarding the economic substance others perceive as aligning with the characteristics. This insight may be helpful as you consider whether the identified differences are meaningful. However, recognition options other than those presented below could be considered if you find that there are inherently different types of leases.

² Note that GASB numbers issues addressed at each meeting. The FASAB equivalent would be “projects.” So, “Issue 1” references “leases” which was the first topic addressed at the September GASB meeting. Also, GASB may provide multiple papers to facilitate discussion of different aspects of a single issue. In this case, “PAPER 1” addresses classification of leases and “PAPER 2” addresses lease terms.

Risks and Benefits of Ownership Approach (GASB Issue 1, Paper 1, pages 7 thru 11)

Current U.S. Lease Accounting Model – Lessee (adopted by FASB, GASB and FASAB)

	Asset	Liability	Expense
Capital Leases - one of four criteria is met and means that the lease transfers the risks and benefits of ownership to the lessee	Recognized at the PV of future cash flows	Recognized at the PV of future cash flows	Depreciation of the asset and interest expense inherent in the lease.
Operating Leases - risks and benefits of ownership are not transferred and such leases are executory contracts	N/A	Unpaid lease payments	Lease payments for use of the asset during the reporting period. (Rent)

Consumption of Economic Benefits Approach (GASB Issue 1, Paper 1, pages 11 thru 17)

FASB/IASB Proposed Lease Accounting Model -- Lessee

	Asset	Liability	Expense
Type A - Consumed (most non-property leases)	Recognize a right-of-use asset, initially measured at the present value of lease payments	Recognize a lease liability, initially measured at the present value of lease payments	Recognize and present the interest on the lease liability separately from the amortization of the right-of-use asset.
Type B - Not consumed (most property leases)	Recognize a right-of-use asset, initially measured at the present value of lease payments	Recognize a lease liability, initially measured at the present value of lease payments	Recognize a single lease cost, combining the interest on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

No classification (GASB Issue 1, Paper 1, page 18 thru 20)

FASB's 2010 Proposal - Single category for lessee accounting

	Asset	Liability	Expense
All types:	Recognize the right-of-use asset initially measured at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee	Recognize a lease liability, initially measured at the present value of lease payments	Recognize and present the interest on the lease liability separately from the amortization of the right-of-use asset.

➤ **Staff Analysis**

Right to Use a Leased Asset

GASB has tentatively agreed that all leases give rise to an asset and liability to be recognized. Further, they tentatively agreed there are not different types of leases that warrant different accounting treatments. In order to assess whether all leases give rise to an asset and liability we must first look at FASAB's definition for asset and liability as outlined in SFFAC 5, *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*.

~~ **Excerpts from SFFAC 5** ~~

Asset

An asset is a resource that embodies economic benefits or services that the federal government controls. [18]

The federal government needs financial, economic, human, and other resources to help it achieve its mission. **In this context, the term resource means “a useful or valuable possession or quality of a country, organization or person” or a “means of supplying a want.”** The government has numerous resources. However, those **resources are not assets unless they have the essential characteristics** of assets and, therefore, meet the definition of assets in paragraph 18. [21]

To be an asset of the federal government, **a resource must possess two characteristics. First, it embodies economic benefits or services that can be used in the future. Second, the government controls access to the economic benefits or services** and, therefore, can obtain them and deny or regulate the access of other entities. [22]

A resource may embody economic benefits even though the federal government cannot exchange it or sell it... Similarly, **the fact that the government's ability to access or use a resource is not legally enforceable does not mean that the resource is not an asset**, if the government nevertheless can obtain the economic benefits or services it embodies and deny or regulate other entities' access to or use of those economic benefits or services. [25]

The **economic benefits or services that a property can provide can be distinguished from the property itself**, whether it is tangible or intangible, such as a right. [27]

Similarly, **lease agreements unbundle the economic benefits or services embodied in leased property** and may, for example, give the lessee the right to hold and use the property and the lessor the right to receive rentals and any residual value. [28]

The second essential characteristic of an asset is control, which refers to the *ability* of the federal government to obtain the economic benefits or services embodied in a resource and to deny or regulate the access of others. It is possible that the government does not actively *exercise* control. [29]

The ability of the federal government to control access to the economic benefits or services embodied in a resource **normally stems from legal rights** and may be evidenced by title deeds, contractual agreements, possession, or other devices that protect the government’s interests. **However, legal enforceability of a right is not a prerequisite to the establishment of control** of access to economic benefits or services, because the government may be able to exercise control in some other way. [30]

Whereas control of access is an essential characteristic of an asset, possession or ownership is not. [31]

Implicit in the definition and essential characteristics of assets is that the event giving rise to the government’s ability to control access to the economic benefits or services embodied in a resource **must have occurred.** [34]

Liability

A liability is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand. [39]

To have a ***present* obligation means that the obligation arose as a result of a past transaction or other event and has not yet been settled.** [42]

To meet **the first essential characteristic** of a liability, **a present obligation must entail the provision of assets (cash, cash equivalents, or goods) or services to another entity in the future.** [43]

The **second essential characteristic** of a liability is that either a **law or an agreement or understanding** between the government and another entity **identifies conditions or events that will determine when the obligation will be settled.** [45]

Current lease guidance distinguishes between types of leased assets based on the evidence of one of the following “bright line” criteria –

- transfer of ownership,
- option to purchase,
- lease term is at least 75% of economic life, or
- present value of lease payments are at least 90% of the fair value of the property.

Because these criteria do not align with the definition of an asset or liability, many believe that these bright line tests are not the appropriate basis for capturing the substance of a lease transaction. As a result, the question becomes should leased property be measured against criteria establishing an asset and liability or against bright line tests.

As noted in the attached lease questionnaire summary, federal entities enter into lease agreements for all types of assets (e.g., buildings, land, equipment, software, etc.). Current lease guidance would treat some of these leased assets differently, recognizing an asset and liability for those meeting the capital lease criteria and only recognizing rent expense for those not meeting the capital lease criteria. As we analyze the merits and deficiencies of the current guidance one question to debate is, are there inherent differences between the leasing of different types of assets that would lead to separate accounting recognition.

Outside of inherent differences, should the lessee's reasons for leasing or their view of the lease payments affect the recognition of the lease transaction. As noted in the attached GASB staff paper, under the FASB/IASB proposal all leases with a maximum possible lease term of more than 12 months would be recognized as a right-to-use asset with an offsetting liability, however some lease arrangements are viewed as financing vehicles and some are viewed as rental payments when expense recognition is made.

Questions for Board Consideration

Question 1: Based on the above definition of an asset, does the Board believe that a federal entity's **right to use** a leased asset meets the definition of an asset to the entity?

Question 2: Based on the above definition of a liability, does the Board believe that a federal entity's **obligation to make lease payments** meets the definition of a liability to the entity?

Staff Recommendation

Staff agrees that in most instances, a federal entity's right to use a leased asset would meet the definition of an asset to the entity and the obligation to make lease payments would meet the definition of a liability to the entity. Staff recommends that the asset and liability definitions in SFFAC 5 be the foundational basis for determining whether a federal entity's right to use a leased asset and the obligation to make lease payments determine whether an asset or liability exist.

Question 3: Based on the GASB staff paper, does the Board support the Type A and Type B consumption based distinction proposed by the FASB and the IASB?

Staff Recommendation

Staff does not support the Type A and Type B consumption based distinction proposed by the FASB /IASB 2013 proposal, primarily because the distinctions between Type A and Type B are not significant enough to justify the complexity involved in making those distinctions. According to the proposal, "The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee **would depend on whether the lessee is expected to consume more than an insignificant portion** of the economic benefits embedded in the underlying asset. For practical purposes, this assessment would often depend on the nature of the underlying asset."

Staff recommends that the Board consider an approach that does not make any inherent distinctions between leases for purposes of selecting an accounting treatment for federal lease reporting, such as the no classification – single category approach proposed in FASB's 2010 proposal.

Question 4: Does the Board believe there are other inherently different types of leases so that a different accounting treatment is needed?

Staff Recommendation

Currently, staff is unaware of other specific inherently different types of leases that would justify a different accounting treatment. Staff recommends further research on this topic and will pose the question to the task force at our first meeting in January 2014.

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MEMORANDUM

Issue 1, Paper 1
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: Classification of Leases

An important aspect of the current guidance on accounting for leases is the classification as either a capital lease or an operating lease. How leases are classified drives the accounting treatment. This paper will examine the characteristics inherent in lease transactions. It will then discuss alternative methods for determining classification categories of leases for accounting and financial reporting purposes.

CHARACTERISTICS INHERENT IN LEASES

A. Introduction

The 2013 Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) revised Exposure Draft (ED) on Leases proposed new classification categories for leases--Type A and Type B leases. These two classification categories reflect the Boards' belief that certain leases are inherently different from one another. Classification is based generally on the extent to which the economic benefits of the underlying assets are consumed. A more complete discussion of the FASB/IASB joint proposal is included later in this paper.

This view differs from the Boards' view in the original ED issued in 2010. The original ED proposed a single classification for lessee accounting, while proposing two different classifications for lessor accounting based on whether lessor retains exposure to significant risks or benefits associated with the underlying asset during the expected lease term. The feedback received on the original ED generally supported the right-of-

use model for both lessee and lessor, but many questioned the inconsistency between the single-classification lessee accounting model and the two-classification lessor accounting model.

Feedback received on the original ED led to the Boards' redeliberation on leases. As a result, in the revised ED, the Boards' view shifted to the acknowledgement of economically different kinds of leases and the resulting dual accounting model.

The project staff thinks it is critical to understand the characteristics inherent in leases in order to understand the economics of leases and therefore any classification distinctions. For the convenience of discussion, two lease examples are provided to analyze and compare the characteristics of leases: (1) a transit district entering into a 40-year lease with a financial institution lessor for a fleet maintenance facility that has an estimated economic life of 50 years, and (2) a city entering into a 2-year lease to use certain office space in a privately-owned building, while the city hall is under renovation.

B. Alternative View 1: There Are No Differences Between These Leases

Under this view, *all* leases are contracts that create substantially the same rights and obligations for both lessee and lessor. From that perspective, there are no differences between these leases.

In the two property lease examples, similarities from the lessee's perspective include the following. Both governments would obtain the right to use the properties during the lease term, and would also need to fulfill the obligations that come with each lease. These obligations are likely to include making lease payments for the use of the space, vacating the properties at the end of the lease term, and perhaps some basic maintenance to keep the properties in specified conditions. At the same time, it is likely that the governments would not be given the right to make substantial modifications to the properties that would alter the appearance and functionality.

Likewise, there are similarities from the lessor's perspective in both leases. The lessor would obtain the right to receive lease payments and to receive the keys back at the end of the lease term. Also, the lessor would need to fulfill its obligations, including providing the access to the lessee to use the property, paying the property taxes and building insurance, and possibly providing some property management services.

C. Alternative View 2: There Are Inherent Differences Between These Leases

Under this view, there are inherent differences that distinguish one type of lease from another. One FASB member's alternative view points out that there is not a uniform view of the economics of leases:

BC356. [This FASB member] does not believe the proposed requirements represent an improvement because they complicate users' abilities to make any adjustments to reported numbers by forcing them (a) to understand which rights and obligations are and are not recognized and measured in lease assets and lease liabilities and (b) to seek and aggregate income and cash flow information from multiple line items across a wide range of different lease contracts. The adjustment process is complicated further by the failure of the proposed guidance to require presentation or disclosure of all the components that comprise the total expense incurred each period under the lease contract. Research during the standard-setting process on this project has indicated that users do not have a monolithic view about the economics of lease contracts, with some users viewing leases primarily as resulting in rental expense while other users viewing leases as financing vehicles and, finally, other users viewing leases as derivatives. That observation suggests that many users will continue to seek information to adjust reported numbers to reflect their varying views of the economics of lease contracts. The proposed requirements do not facilitate making such adjustments and, therefore, [this FASB member] believes they represent a step backward from the current requirements. [Underlining added for emphasis.]

Using the same two property lease examples, the supporters of this view would argue the following in support of the statement that there are different types of leases.

i. A 40-year facility lease is more like a financed purchase/sale than a 2-year office space lease for the reasons below.

1. The lease payment includes a much greater financing component. Because the 40-year duration of the lease constitutes a more significant portion of the economic life of the facility (which has an estimated economic life of 50 years), in comparison to the 2-year office space lease, the lessor would be expected to charge lease payments that covers not only (a) an amount representing the portion of the facility's economic life expected to be used up by the lessee over the 40-year term, but also (b) an amount providing the lessor with a return on its investment in the remaining portion of the facility's economic life. With a longer lease term, the "interest" portion factored in the lease payments would be greater in a 40-year lease than that in a 2-year lease. Therefore, the greater significance of the financing element to the overall transaction in a 40-year lease makes the lease more like a financing deal for the acquisition of an asset, in which the lessee is allowed to make installment payments toward a property purchase loan.

2. In a 40-year lease, the lessee would be expected to use a significant portion of the service capacity of the facility during the lease term, whereas a 2-year office space lease would use an insignificant portion of the service capacity of the office building, leaving virtually the same service capacity as the building had at the commencement of the lease.

3. In a 40-year lease, the lessee may be subject to additional obligations that are unlikely to be included in a 2-year lease. For example, in the longer lease, the lessee may be required to keep frequent facility maintenance, such as electric, plumbing, central heating and air conditioning check-up, regular cleaning, and so on, depending on the terms of lease. Thus, the longer-term lessee generally obtains more of the rights and obligations of ownership, making the substance of the transaction more like a purchase.

4. On the other hand, it is also worth noting that although the 40-year lease is similar to a financed purchase/sale, it is different because the rights and obligations vary under those two types of transactions. In a purchase of a facility that is financed, all the rights and obligations associated with ownership of the facility would be transferred to the buyer from the seller, whereas in a 40-year lease some of those rights and obligations would be retained by the lessor. Although the lessor gives the lessee the right to use the facility, the lessor retains certain rights and obligations of ownership, such as legal title, right to sell the facility (assuming buyer agrees to keep the lease in place), and right to do as it pleases with the facility once it is returned at the end of the lease term. In other words, in the 40-year lease, not all rights and obligations associated with the facility would be transferred from the lessor to the lessee, as they would in a purchase. A lessor retains some degree of control over the facility, while a seller does not.

ii. Another argument in support of alternative view 2 is the different business reasons for entering into the lease in the two examples.

1. The supporters of this view believe that not all leases are entered into for the purpose of alternative financing. In some cases the purpose of the lease is to create flexibility, mitigate the risk of ownership, and/or outsource significant activities principally related to maintenance and administration of an asset. The 2-year office space lease is such an example. In that instance, the city needs temporary work space to house its employees and maintain its operations as a municipality while the renovation of the city hall is ongoing for that timeframe. From a business reason perspective, the city determines that it is preferable to lease the temporary office space rather than to purchase a piece of property for a relatively short period of time. There are also cases when the leased asset is not available to be purchased. For example, a private party enters into a lease with a county for retail space at the county's airport. In this scenario, there are

no other options for the lessee to obtain the use of the asset without a lease. Proponents of alternative view 2 believe that different business reasons for entering into the leases are another key difference that presents compelling evidence to support the statement that there are different types of leases.

2. However, reasons for entering into a lease could also be an alternative method of financing the asset needs of the government. Governments may have the option to lease or purchase an asset, and many factors may play into the lease-or-buy decision. However, one strong factor may be avoidance of statutory debt limitations if the lease would result in operating treatment under current guidance. A city may consider purchasing a fleet of work vans under a financing arrangement, but ultimately chooses to enter into an operating lease for them instead, in order to avoid incurring additional debt. This supports the notion that a lease is similar in substance to a financed purchase. However, because alternative financing is not always the reason for the lease transaction, supporters of this view argue that there are different types of leases.

iii. Alternative view 2 also is consistent with current accounting literature. Under the current GASB literature (mostly found in Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraphs 211–271), the different accounting treatment of leases stems from the belief that some leases are financing arrangements and others are not.

D. Staff Recommendation

Based on the analysis above, the project staff believes the characteristics inherent in leases present compelling evidence that there is more than one type of leases. The project staff recommends that the Board acknowledge that there are different types of leases.

Board Discussion Question

Question 1

Does the Board believe there are inherently different types of leases?

The project staff believes that there are inherently different types of leases.

CLASSIFICATION OF LEASES

If the Board tentatively decides that there are different types of leases, then the next question is how the distinction for financial reporting purposes, if any, should be made. The following discussion examines potential methods for dividing leases into classification categories for accounting purposes.

Current FASB/IASB/GASB Model: Classification Depends on Risks and Benefits of Ownership

Under the current GASB literature found in Statement 62, a lease that transfers the risks and benefits of ownership from the lessor to the lessee is analogized to a sale and purchase and is considered to be a capital lease. Lease payments are characterized as comparable to those arising from an installment sale and purchase. Leases that do not make that transfer of risks and benefits are considered executory contracts. The organizing idea for the benefits and risks notion is found in the Basis for Conclusions of FASB Statement No. 13, *Accounting for Leases*:

60. The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits

and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. This is not to say, however, that such transactions are necessarily "in substance purchases" as that term is used in previous authoritative literature.

Bright-line criteria that define when risks and rewards have been transferred are found in paragraph 213 of Statement 62:

If at its inception a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease.

- a. The lease transfers ownership of the property to the lessee by the end of the lease term. [Footnote omitted.]
- b. The lease contains a bargain purchase option.
- c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease.
- d. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance and maintenance to be paid by the lessor, including any gain thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by and expected to be realized by the lessor. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease. A lessor should compute the present value of the minimum lease payments using the interest rate implicit in the lease. A lessee should compute the present value of the minimum lease payments using its incremental borrowing rate, unless (1) it is practicable to obtain 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 of those conditions are met, the lessee should use the implicit rate.

An alternative to these bright-line criteria can be found in the current IASB literature in IAS Statement No. 17, *Leases*. IAS 17 characterizes capital leases as financing leases.

Classification of leases

7. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

8. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

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10. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

11. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- (a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- (c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

12. The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Arguments in Support of a Benefits/Risks Approach

Setting aside recognition and measurement issues, to be addressed later in this project, the benefits and risks approach is a way to separate leases that are similar to a purchase from those that are not, and thus allow for different accounting treatment. If certain leases are economically similar to installment sales and others are not, this is a way to make the distinction. That was the argument used in the Basis for Conclusions to FASB Statement 13, as quoted above. The distinctions are by now familiar to preparers, auditors, and financial statement users. The bright line approach provides a clear basis for distinguishing between leases. While the bright line approach has been widely criticized for allowing lease agreements to be structured to achieve a certain accounting effect, the IASB's approach uses the same concepts but eliminates the bright line tests. One FASB member's alternative view (paragraph BC360) advocates this constructive purchase/sale distinction, though he then recommends that any transaction meeting the criteria be scoped out of the leasing guidance and accounted for in accordance with other literature.

Arguments Against a Benefits/Risks Approach

This approach has been criticized because it is viewed as overly complex, and its application leads to most leases to be classified as operating leases. In the FASB's and IASB's view as expressed in the original Exposure Draft, the current approach means

that economically similar transactions can be accounted for very differently and the dividing line between finance and operating leases is difficult to define in a principled way (Appendix C, paragraph C.10). Additionally, if the general concepts were kept but the bright lines eliminated (like the current IAS 17 approach), it is likely that many practitioners would still default to those bright line percentages to interpret the guidance, because that is what is familiar to them. Additionally, some may see this approach as inconsistent with a conceptual view of accounting based on rights and obligations.

FASB and IASB's Proposal: Classification Depends on Consumption of Economic Benefits

The proposal in the recently issued FASB and IASB revised ED is characterized as a right-of-use model: that is, based on the rights and obligations created by a lease. Classification depends on consumption of economic benefits. Upon the commencement of a lease, a lessee obtains a right to use the underlying asset (and therefore a right to consume the economic benefits) while the lessor has relinquished that right. The proposal recognizes that all leases give rise to those rights. However, the proposal uses the extent of consumption of the total economic benefits as the dividing line between classifications because this results in a difference in what the lease payments represent.

BC43. The rationale for the classification principle proposed to distinguish between different leases is based on the fact that the lessee has the right to use *all* of the underlying asset during the period of the lease—that is, by definition; the lessee controls the use of the underlying asset during the lease term. Accordingly, from an economic perspective, and subject to market constraints, a lessor would generally price a lease to ensure that it obtains a desired return on its total investment in the underlying asset and also to recover an amount representing the portion of the underlying asset that the lessee is expected to consume during the lease term.

Characterizations of Lease Payments

According to the revised ED, under one kind of lease, lease payments represent amounts that provide the lessor with a return on its investment in the underlying asset. Such payments have been analogized to an interest-only loan. That is, the lessee “borrows” the asset and returns it to the lessor with the same value or service potential as it had at the start of the lease:

BC44. When there is no expected decline in the value or service potential of the asset (that is, when the lessee is not expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset), the lease payments made by the lessee would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, that is, a charge for the use of the asset by the lessee. That return or charge would be expected to be even, or relatively even, over the lease term. In many respects for such a lease, the payments made by the lessee could be viewed as somewhat similar to an entity paying interest on an interest-only loan. That is because the lessee “borrows” the underlying asset, uses it during the lease term while paying the lessor even (or relatively even) lease payments for that use (providing the lessor with a constant return on its investment in the asset), and returns the underlying asset to the lessor with virtually the same value or service potential as it had at the commencement date. In the case of a lease, however, the asset “loaned” to the lessee is a tangible asset rather than a financial asset.

This is similar to the idea used in GASB Statement No. 60, *Service Concession Arrangements*, where the transferor government is “entitled to significant residual interest in the service utility of the facility at the end of the arrangement.”

On the other hand, under the other kind of lease, payments are viewed as representing a lessor’s return on its investment and recovery of the economic benefits the lessee is expected to consume during the lease term:

BC45. In contrast, when the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the

underlying asset, the lessor would charge the lessee for recovery of that portion of the underlying asset that the lessee is expected to consume during the lease term, as well as obtaining a return on its investment in the asset. The lease payments and, thus, the right-of-use asset, would incorporate the acquisition of the portion of the underlying asset that the lessee is expected to consume. When that is the case, the Boards concluded that accounting for the right-of-use asset similar to other nonfinancial assets (such as property, plant, and equipment) would provide the most useful information to users of financial statements about the nature of such leases.

Based on this view of the economic substance of the lease payments, the FASB and the IASB propose to classify leases into Type A and B leases. In Type A leases, the economic benefits of the underlying asset are significantly consumed, while in Type B leases, they are not. To facilitate making the classification, the revised ED states that Type A leases generally apply to leases of equipment, while Type B leases generally apply to real estate. This is because generally, equipment is consumed through use and real estate is not. However, two exceptions are provided in an effort to discourage lease classification based on an underlying asset that does not reflect the substance of the transaction. Those exceptions provide insight into the premise of the two types. The first exception focuses on the lease term. A lease of property that consumes the major part of the remaining economic life of the underlying asset would be a Type A lease, and a lease of equipment that consumes an insignificant part of the total economic life of the underlying asset would be a Type B lease. The second exception evaluates the present value of lease payments. Lease payments for property that account for substantially all of the fair value of the underlying asset would be Type A leases, and lease payments for equipment that are insignificant relative to the fair value of the underlying asset would be Type B leases.

842-10-25-5 At the commencement date, an entity shall classify a lease as either a Type A lease or a Type B lease. An entity shall not reassess the classification after the commencement date.

842-10-25-6 If the underlying asset is not property, an entity shall classify a lease as a Type A lease unless one of the following two criteria is met:

- a. The lease term is for an insignificant part of the total economic life of the underlying asset.
- b. The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type B lease.

842-10-25-7 If the underlying asset is property, an entity shall classify a lease as a Type B lease unless one of the following two criteria is met:

- a. The lease term is for the major part of the remaining economic life of the underlying asset.
- b. The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

If either criterion above is met, the lease is classified as a Type A lease.

The revised ED provides these illustrations of lease classification:

> > **Illustrations of Lease Classification**

842-10-55-61 The following Examples illustrate lease classification.

> > > **Example 11—Equipment Lease Classification**

842-10-55-62 A lessee enters into a 2-year lease of an item of equipment, which has a total economic life of 12 years. The lease payments are CU9,000 per year, the present value of which is CU16,700, calculated using the rate the lessor charges the lessee. The fair value of the equipment at the commencement date is CU60,000.

842-10-55-63 The lessee determines that the lease is a Type A lease because of the following:

- a. The underlying asset is not property.
- b. The lease term is for more than an insignificant part of the total economic life of the equipment.
- c. The present value of the lease payments is more than insignificant relative to the fair value of the equipment at the commencement date.

> > > Example 12—Commercial Property Lease Classification

842-10-55-64 A lessee enters into a 15-year lease of an office building, which has a remaining economic life of 40 years at the commencement date. The lease payments are CU30,000 per year, the present value of which is CU300,000, calculated using the lessee's incremental borrowing rate (that is, the rate the lessor charges the lessee is not readily determinable to the lessee). The fair value of the property at the commencement date is CU400,000.

842-10-55-65 The lessee determines that the lease is a Type B lease because of the following:

- a. The underlying asset is property.
- b. The lease term is not for a major part of the remaining economic life of the property.
- c. The present value of the lease payments does not account for substantially all of the fair value of the property.

The FASB's staff paper on this topic acknowledged that this approach "may not have a strong conceptual premise, but it may result in a practical basis for distinguishing leases" (FASB Staff Memo 161, paragraph 28).

Arguments for the Consumption Approach

The consumption approach, as described in the revised ED, would ultimately result in different accounting treatment for what is believed to be a different economic substance in the lease payments. It also would treat most real estate leases as Type B leases. The FASB research indicates this approach would be consistent with the feedback received from many preparers and financial statement users. Specifically, the approach reflects that real estate leases are frequently not entered into as an alternative to acquiring the underlying asset (*ibid.*, paragraph 26). Therefore, it recognizes that these leases are different from those entered into as an alternative financing arrangement. This also is a different approach from current practice, which would move away from the concerns of the bright-line tests and their implications. Feedback

from the project task force indicated general agreement with these classification criteria.

Arguments Against the Consumption Approach

One argument against this approach is it still creates complexity in the lease literature, and perhaps would not be cost-beneficial. One FASB member’s alternative view states:

[The] introduction of a new classification system is not an improvement and, in fact, could add greater complexity for users, preparers, and auditors. Furthermore, he questions whether necessary classification assumptions will be operable and auditable.

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[This FASB member] does not believe that the consumption of an asset should affect for financing costs of a related liability. [paragraphs BC 375–376]

Another argument against the consumption approach is that “application guidance would need to be developed relating to the point at which the right of use is determined to consume enough of the underlying asset for the transaction to be accounted for as a finance lease (for example, would a 50-year lease of a building be determined to consume the economic benefits of the underlying building?)” (FASB Staff Memo 161, paragraph 27(b)).

Consumption of Economic Benefits and the GASB Literature

The FASB’s proposal’s focus on economic benefits is appropriate based on its definition of an asset—“probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” (FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 25). When considering the underlying asset in a lease, it has the ability to provide economic benefits at the start of the lease. At the end of the lease, it may have the same ability to provide economic benefits, or it

may have less due to the lessee's consumption. However, the GASB's definition of an asset describes assets as "resources with present service capacity that a government presently controls" (Concepts Statement No. 4, *Elements of Financial Statements*, paragraph 8). Again considering the underlying asset in a lease, it would have service capacity at the start of the lease. At the end of the lease, it may have the same service capacity, or it may have less due to the lessee's consumption. Therefore, in the context of the FASB's proposed consumption approach, the project staff believes that the term "economic benefits" could be exchanged for "service capacity" with the same result. Additionally, paragraph 42 of the Basis for Conclusions of Statement 60 mentions "future service potential or economic benefit" as effects of a facility having a significant service utility.

Other Classification Methods

In addition to delineation based on risks and benefits of ownership (current guidance) and consumption of economic benefits (proposed guidance), there could be additional methods of separating leases into categories for accounting purposes. Returning to the property lease examples used in the first part of this paper, other distinctions between the 40-year facility lease and 2-year office space lease are the purpose of the agreement and the significance of the financing element due to the duration of the agreement.

In the project staff's view, classifying leases based on purpose or intent is a precarious proposition. While classifying leases meant as alternative financing arrangements separately from those that are intended for other purposes makes conceptual sense, the project staff believes the practical considerations outweigh the benefits. Intent can be difficult to determine, and even more difficult to audit. There also could be situations in which there is more than one purpose for the lease. Additionally, the Board has previously rejected "management's declared objective" as a criterion for determining if a derivative instrument qualifies for hedge accounting (Statement No. 53, *Accounting*

and Financial Reporting for Derivative Instruments, Basis for Conclusions, paragraphs 112 and 113). Therefore, the project staff does not believe this is a viable method for determining lease classifications.

The significance of the financing element also could be a conceptually solid way of segregating leases into categories. This attempts to separate agreements so ones with a more significant financing component can be accounted for like other financing transactions, a view of substance over form. The approach taken in the FASB's revised ED based on the characterization of lease payments could be seen as trying to represent the financing element. However, it also raises issues of complexity. Many financings state the interest rate or even have an amortization table that shows the portion of each payment that represents principal versus interest. In contrast, lease contracts often do not provide this information. Lessees and lessors would first have to make judgments about what the financing element of the contract is before they could assess it against the criteria that would be put forth for making the distinction. The project staff believes that the FASB's proposed consumption approach, being similar in concept, would be preferable to significant financing element for this reason.

Alternative – No Classification

An additional alternative is to decide that no classification is necessary for accounting purposes. This alternative acknowledges the differences inherent in different lease contracts, but does not believe the differences warrant different accounting treatment. While some leases have a more significant financing element, and there are various business reasons for entering into the agreements, the accounting for the leases should be based on the rights and obligations that are common across the leasing spectrum. For example, all leases, by the definition on which the Board has tentatively decided, involve the lessee obtaining a right to use an asset and an obligation to pay for it. The project staff acknowledges that there could be variations in the individual rights that

comprise the right to use—some leases might have more restrictions on what the lessee can do with the asset. Further consideration of that notion may indicate that arrangements in which rights and obligations are significantly limited could potentially exempt those arrangements from the requirements of the standard that ultimately results from this project (rather than establish a different classification within the standard).

This alternative reduces the complexity of two models and also eliminates the ability to engineer lease agreements to fit a certain model. However, it also could be seen as oversimplifying a complicated subject. Others may argue that basing the accounting for leases on the rights and obligations common in lease agreements is inappropriate and if the accounting were based on the significance of a financing element (for example), two classifications would be more appropriate. Feedback received from the project task force indicated general agreement with the notion of having two classification categories.

While the FASB's and IASB's revised EDs propose a dual model approach, there was disagreement on this point. Two of the three FASB members who provided alternative views to the revised ED acknowledged the complexity as a downside to the dual model approach. One suggested a single model but with scope adjustments (BC359-360) while the other indicates that the proposed classification method does not improve the complexity level (BC375-376). Both of the IASB members who provided alternative views cited disagreement with the dual model aspect of the proposal. Basis for Conclusions paragraph 394:

[These IASB members] disagree with the dual accounting model proposed for both lessees and lessors (as described in paragraphs BC397–BC401), which in their view undermines the principles underlying the proposed right-of-use model, is operationally complex and creates structuring opportunities.

Staff Analysis

The project staff believes that both the current (risks and benefits of ownership) and the proposed (consumption of economic benefits) classification methods could be appropriate ways to segregate leases for accounting purposes. However, the project staff also sees the merit to the cost-benefit arguments regarding the complexity of having classifications at all. Based on the FASB's proposed recognition and measurement for lessees, the only differences the classification makes is in the rate at which the right-of-use asset is amortized, and the income statement (and cash flow) presentation of lease-related expense. Their proposed recognition and measurement for lessors, however, does vary significantly.

However, if the Board believes that leases should be classified, then the project staff believes that that classification should be on the basis of the consumption of economic benefits. The project staff also believes that the criteria set forth by the FASB and IASB in the revised ED also should be used in this project. With some lease payments akin to interest-only and others like interest plus return on investment, it is logical that these leases would have different accounting treatment, which is the ultimate goal of making the classification. The classification expedient based on the nature of the underlying asset helps to simplify the process, while the exceptions allow for appropriate classification in unusual situations.

If, however, the Board tentatively believes that classification should be on the basis of transfer of risks and benefits of ownership, the project staff believes that criteria currently used in IAS 17 should be used in this project. This separates leases that are like purchases from those that are not, but without the bright-line tests.

Board Discussion Questions

Question 2

Do any inherent differences in types of leases result in the need for different accounting treatment between those types?

The project staff believes that the inherent differences in leases do not warrant different accounting treatment, and a single accounting model should be developed based on the rights and obligations common to all leases.

Question 3

If the Board tentatively believes that leases should be classified, on what basis should that classification be made?

- a. **Transfer of benefits and risks of ownership as described in the current FASB, IASB, and GASB lease literature.**
- b. **Right-of-use model that focuses on consumption of economic benefits as proposed in the FASB and IASB's revised ED.**
- c. **Another basis, such as purpose for the transaction or the significance of a financing element.**

If the Board tentatively believes that leases should be classified, then the project staff believes that that classification should be on the basis of the consumption of economic benefits.

Question 4A

If the Board tentatively believes that leases should be classified on the basis of transfer of risks and benefits of ownership, what criteria should be used to make the distinction?

The project staff believes that classification similar to the current IAS 17 (transfer of substantially all the risks and rewards of ownership, with judgmental factors that might indicate when such a transfer has taken place) would be appropriate criteria.

Question 4B

If the Board tentatively believes that leases should be classified on the basis of consumption of economic benefits, what criteria should be used to make the distinction?

The project staff believes that classification similar to the FASB's revised proposal (first based on the nature of the underlying asset, with exceptions based on the lease term and present value of payments) would be appropriate criteria.

DRAFT OF A STANDARD

The following draft standard is based on the assumption that the Board has tentatively decided that there should be classifications made for accounting for leases, and tentatively decided on the staff's recommendations for the basis and criteria for making that distinction. If the Board tentatively decides that classifications are not necessary, there would be no draft standard for this subject.

Classification of Leases

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- XX. At the beginning of the lease term, a lease should be classified as either Type A or Type B.
- XX. If the underlying asset of a lease is *not* property (land or a building, or part of a building, or both), the lease normally should be classified as a Type A lease. However, it should be classified as a Type B lease if one of these criteria is met:

- 9 a. The lease term is for an insignificant part of the total economic life of the
10 underlying asset.
11 b. The present value of the lease payments is insignificant relative to the fair
12 value of the underlying asset at the beginning of the lease term.
13
- 14 XX. If the underlying asset of a lease is property (land or a building, or part of a
15 building, or both), the lease normally should be classified as a Type B lease.
16 However, it should be classified as a Type A lease if one of these criteria is met:
17 a. The lease term is for the major part of the remaining economic life of the
18 underlying asset.
19 b. The present value of the lease payments accounts for substantially all of the
20 fair value of the underlying asset at the commencement date.

Board Discussion Question

Question 5

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.

Major Tentative Decisions

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.)
- 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
- Leases that transfer ownership not qualify for the short-term lease exception, even if they meet the other criteria
- 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 definition of a short-term lease not depend on the presence of a purchase option
- 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
- 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
- Prepayments (amounts paid for the lease prior to measuring the lease liability) be included in the value of the recorded lease asset
- Lease incentives received be reductions in the cost of lease assets
- Initial direct costs be capitalized if they are ancillary charges to place the leased asset into use or expensed if they are other costs.