



October 9, 2014

Memorandum

To: Members of the Board
From: *M.R. Valentine*
Monica R. Valentine, Assistant Director
Wendy M. Payne
Through: Wendy M. Payne, Executive Director
Subj: Leases Project – **Tab G**¹

MEETING OBJECTIVES

To review proposed accounting guidance for intragovernmental lease arrangements.

BRIEFING MATERIAL

This transmittal memorandum includes proposed recognition and disclosure accounting guidance for intragovernmental lease arrangements for both the lessee and lessor.

BACKGROUND

At the August meeting the Board discussed and agreed to a definition for the term “intragovernmental” to refer to occurring within a consolidation entity or within or between two or more consolidation entities.

The Board discussed and agreed to proposed definitions of leases and of intragovernmental lease arrangements.

The Board discussed staff's proposal for recognizing operating leases--straight-line for lease costs and in the current period for executory costs. The Board members agreed with the straight-line concept for lease payments, but would like additional information before deciding whether executory costs should be required to be separated from the rental payment.

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.

The next decision related to the proposed disclosure of future lease payments. Some questioned whether this disclosure was necessary for intragovernmental lease arrangements. The Board agreed to exclude the disclosure, but to ask a question in the exposure document whether the disclosure is necessary.

The Board agreed that the lessor revenue recognition would match the lessee's expense recognition—on the straight-line basis.

The Board agreed that upfront lease costs for lessors would be expensed. Regarding potential disclosures of future lease payments of lessors, there were no objections to the proposed disclosures.

NEXT STEPS

Staff will continue to work with the task force to further develop the intragovernmental lease guidance. Staff will also continue to follow the progress of GASB's lease project – their preliminary views document is expected to be released next month for comment.

QUESTION FOR THE BOARD

Does the Board agree with staff's proposed recognition and disclosure accounting guidance for intragovernmental lease arrangements for both the lessee and lessor?

MEMBER FEEDBACK

Please contact me as soon as possible to convey your questions or suggestions. Communication before the meeting will help make the meeting more productive. You can contact me by telephone at 202-512-7362 or by e-mail at valentinem@fasab.gov with a cc to paynew@fasab.gov

PROPOSED ACCOUNTING GUIDANCE FOR INTRAGOVERNMENTAL LEASE ARRANGEMENTS

Definitions for Intragovernmental Lease Arrangements

Lease

A contract or agreement that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

Intragovernmental

Occurring within a consolidation entity or between two or more consolidation entities as defined under SFFAS 47 (Reporting Entity).

Intragovernmental Lease Agreement

A lease occurring within a consolidation entity or between two or more consolidation entities as defined under SFFAS 47 (Reporting Entity).

Intragovernmental Lease Inception

The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment should be in writing, signed by the intragovernmental parties in interest to the transaction, and should specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition. [*Adapted: ASC 840-20-20 Glossary*]

Intragovernmental Minimum Lease Payments

- For a **lessee**, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property excluding both of the following:
 - a. Contingent rentals
 - b. The lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property. [*Adapted: ASC 840-10-25-5*]
- For a **lessor**, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, including any guarantee of the residual value, but excluding both of the following:
 - a. Contingent rentals
 - b. The lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property. [*Adapted: ASC 840-10-25-7*]

Intragovernmental Lease Term

The period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period). [*Adapted: GASB's Tentative Decisions on Lease Project*]

Intragovernmental Sublease

A transaction in which a leased property is re-leased by the original lessee to a lessor within the same or another consolidation entity, and the intragovernmental lease agreement between the two original parties remains in effect. [*Adapted: ASC 840-20-20 Glossary*]

Intragovernmental Lease Arrangements – Lessee Accounting

The following sections articulate general recognition guidance for intragovernmental lease arrangements. They also provide more detailed recognition guidance regarding several specific intragovernmental lease topics as well as disclosure guidance.

Recognition

General Guidance for Recognition of Intragovernmental Lease Arrangements

Intragovernmental rent should be charged to expense by lessees over the lease term. If rental payments (i.e., minimum lease payments) are not made on a straight-line basis, rental expense should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used. [*Adapted: ASC 840-20-25-1*]

Guidance for Recognition of Specific Intragovernmental Lease Topics

Nonlevel Rents

Certain intragovernmental lease arrangements specify scheduled rent increases over the lease term. The following are two nonlevel rents types:

- a. Scheduled rent increases that are not dependent on future events. Scheduled rent increases, which are included in minimum lease payments, should be recognized by lessees on a straight-line basis over the lease term in accordance with the general recognition guidance above.
- b. Contingent rentals. Increases or decreases in rentals that are dependent on future events such as future sales volume, future inflation, future property taxes, and so forth. A lessee should recognize contingent rental expense when the contingent event is becomes probable. If the lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting should reflect those different circumstances. [*Adapted: ASC 840-20-25-2 & ASC 840-10-25-35*]

Lease Incentives

Intragovernmental lease incentives include payments made to or on behalf of the lessee. Lease incentives should be recognized as reductions of rental expense by the lessee on a straight-line basis over the term of the lease in accordance with the general recognition guidance above.

The lessee's immediate recognition of expenses or losses, such as moving expenses, losses on subleases, or the write-off of abandoned leasehold improvements, is not changed by the lessor's assumption of those expenses or losses. [*Adapted: ASC 840-20-25-6*]

Rent Holidays

Rent holidays in an intragovernmental lease should be recognized by the lessee on a straight-line basis over the lease term (including any rent holiday period) in accordance with the general recognition guidance. *[Adapted: SEC Staff Letter February 7, 2005]*

Build-to-Suit Leases

In the case of a build-to-suit intragovernmental lease arrangement (i.e., lessor constructed), the lessee should consider construction period lease payments made before the beginning of the lease term to be prepaid rent. *[Adapted: ASC 840-20-25-8]*

Rent Expense During Construction

In some intragovernmental lease arrangements, an entity (lessee) may take possession or be given control of leased property before it commences operations or makes rental payments under the terms of the lease. During this period, the lessee has the right to use the leased property and does so for the purpose of constructing a lessee asset (for example, leasehold improvements). After construction is completed, the lessee commences operations and is required to make rental payments under the terms of the lease. Alternatively, some lease arrangements require the lessee to make rental payments when the lessee takes possession or is given control of the leased property.

Rental costs associated with building and land intragovernmental lease arrangements incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a lessee asset. There is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, rental costs associated with land or building intragovernmental lease arrangements that are incurred during a construction period should be recognized by the lessee as rental expense. A lessee should follow the general recognition guidance in determining how to allocate rental costs over the lease term. *[Adapted: ASC 840-20-25-10]*

Subleases

If the nature of an intragovernmental sublease is such that the original lessee is not relieved of the primary obligation under the original operating lease, the original lessee (as sublessor) should account for both the original lease and the new lease as intragovernmental leases.

If costs expected to be incurred under an intragovernmental sublease exceed anticipated revenue on the intragovernmental sublease, a loss should be recognized by the sublessor. *[Adapted: ASC 840-20-25-14]*

Amortization of Leasehold Improvements

Leasehold improvements in intragovernmental lease that are placed in service significantly after and not contemplated at or near the beginning of the lease term should be amortized over the shorter of the following terms:

- a. The useful life of the assets.
- b. A term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the context of the definition of lease term) at the date the leasehold improvements are purchased.

The guidance in the preceding paragraph does not apply to preexisting leasehold improvements and, thus, should not be used to justify the reevaluation of the amortization period for preexisting leasehold improvements for additional renewal periods that are reasonably assured when new leasehold improvements are placed into service significantly after and are not contemplated at or near the beginning of the lease term. [*Adapted: ASC 840-10-35-6*]

Determining Whether a Lease Modification Involves a Termination Penalty

This guidance addresses how, in the circumstances described, the adjustment to the lease term and the increase in the lease payments over the shortened lease period should be accounted for by the lessee. An entity leases an asset under an intragovernmental lease for use in its operations. Before the expiration of the original lease term, the lessee and lessor agree to modify the lease by shortening the lease term and increasing the lease payments over the shortened lease period.

The treatment by the lessee of the increase in the lease payments over the shortened lease period is a matter of judgment that depends on the relevant facts and circumstances. If the increase is, in substance, only a modification of future lease payments, the increase should be accounted for by the lessee prospectively over the term of the modified lease. If the increase is, in substance, a termination penalty, it should be charged by the lessee to income of the period of the modification. Factors to consider in determining the nature of the increase include both of the following:

- a. The term of the modified lease as compared with the remaining term of the original lease. The shorter the term of the modified lease is in comparison to the remaining term of the original lease, the more likely it is that the increase in the lease payments represents a termination penalty.
- b. The relationship of the modified lease payments to comparable market rents. The closer the modified lease payments are to comparable market rents, the more likely it is that the increase in the lease payments represents a modification of future lease payments.

If the increase in the lease payments represents a termination penalty, the amount of the charge should be calculated by the lessee as the excess of the modified lease payments over the lease payments that would have been required over the shortened

period under the original lease. The amount to be recognized by the lessee may be based on either undiscounted or discounted amounts provided that the accounting policy is consistently applied and disclosed. [*Adapted: ASC 840-20-55-4*]

Renewal or Extension of an Intragovernmental Lease

An existing lease is considered a new lease agreement for accounting purposes when it is renewed or extended beyond the original lease term. The exercise of a renewal option included as part of the original lease term does not create a new lease for accounting purposes as that renewal was already included in the existing lease accounting (e.g., included in the assessment of determining straight-line rentals). However, the exercise of a renewal option that was not deemed part of the original lease term, or entering into a new agreement that goes beyond the original lease term, would automatically create a new lease for accounting purposes. [*Adapted: ASC 840-10-35-4 & 840-30-35-17*]

Disclosures

Lessees of intragovernmental lease arrangements disclose the following:

- a. Lessees should disclose rental expense for each period for which a statement of net cost is presented. Rental payments under leases with terms of a month or less that were not renewed need not be included.
- b. Lessees should disclose a general description of the lessee's leasing arrangements including, but not limited to,
 1. the existence and terms of renewal and escalation clauses.
 2. any opt-out provisions or other end of lease obligations.

Intragovernmental Lease Arrangements – Lessor Accounting

The following sections articulate general recognition guidance for intragovernmental lease arrangements. They also provide more detailed recognition guidance regarding several specific intragovernmental lease topics as well as disclosure guidance.

Recognition

General Guidance for Recognition of Intragovernmental Lease Arrangements

Intragovernmental rent should be reported as income by lessors over the lease term. If rental payments (i.e., minimum lease payments) are not made on a straight-line basis, rental income should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used. [*Adapted: ASC 840-20-25-1*]

Guidance for Recognition of Specific Intragovernmental Lease Topics

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Intragovernmental lease incentives include payments made to or on behalf of the lessee. Lease incentives should be recognized as reductions in rental income by the lessor on a straight-line basis over the term of the lease in accordance with the general recognition guidance above. [*Adapted: ASC 840-20-25-6*]

Rent Holidays

Rent holidays in an intragovernmental lease should be recognized by the lessor on a

straight-line basis over the lease term (including any rent holiday period) in accordance with the general recognition guidance. [*Adapted: SEC Staff Letter February 7, 2005*]

Initial Direct Costs

Lessor initial direct costs for intragovernmental lease agreements should be expensed when incurred by the lessor.

Disclosures

Lessors of intragovernmental lease arrangements disclose the following:

- a. Lessors should disclose future minimum lease rental income as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years for intragovernmental lease arrangements over the period of expected or planned occupancy.
- b. Lessors should disclose a general description of the lessor's leasing arrangements.

History of Board Lease Discussions

- ❖ At the August meeting the Board discussed and agreed to a definition for the term “intragovernmental” to refer to occurring within a consolidation entity or within or between two or more consolidation entities.

The Board discussed and agreed to proposed definitions of leases and of intragovernmental lease arrangements.

The Board discussed staff's proposal for recognizing operating leases--straight-line for lease costs and in the current period for executory costs. The Board members agreed with the straight-line concept for lease payments, but would like additional information before deciding whether executory costs should be required to be separated from the rental payment.

The next decision related to the proposed disclosure of future lease payments. Some questioned whether this disclosure was necessary for intragovernmental lease arrangements. The Board agreed to exclude the disclosure, but to ask a question in the exposure document whether the disclosure is necessary.

The Board agreed that the lessor revenue recognition would match the lessee's expense recognition—on the straight-line basis.

The Board agreed that upfront lease costs for lessors would be expensed

Regarding potential disclosures of future lease payments of lessors, there were no objections to the proposed disclosures.

- ❖ At the June 2014 Board meeting a majority of the Board agreed with a simplified approach for recognizing amounts arising from intragovernmental lease arrangements. The Board agreed that intragovernmental lease arrangements should be accounted for differently than leases between federal entities and non-federal entities.

The Board suggested referring to the project as “leases, including similar intragovernmental lease arrangements” (similar intragovernmental lease arrangements are in substance leases) to differentiate the intragovernmental arrangements from the non-federal arrangements. This would allow the two types of transactions to be disclosed separately.

The Board also agreed not to pursue issuing a preliminary views (PV) document on leases and to tentatively plan to issue its exposure draft (ED) on leases and other similar arrangements close to when the Governmental Accounting Standards Board (GASB) will issue its ED. Because GASB plans to issue a PV prior to its ED, staff will have an opportunity to seek informally feedback from the federal community on the GASB PV.

- ❖ At the April 2014 meeting the U.S. General Services Administration (GSA) provided an educational session with the goal of the Board gaining a better understanding of several GSA lease-related topics.
- ❖ At the March 2014 the Board met jointly with the GASB to discuss similar issues related to each of their ongoing lease accounting projects. Both Boards agreed that

they should begin with the goal of developing symmetry between the lessee and lessor models. The FASAB was also very focused on the intragovernmental leasing issues involving federal entities and those federal-specific lease issues.

- ❖ In January 2014 staff asked the Board to provide their input in a survey format on the tentative decisions made by the GASB on their lease project to date. Based on the results of the survey, staff identified several topics for further discussion during the joint meeting with GASB.
- ❖ At the December 2013 meeting the Board briefly discussed the GASB tentative decisions on their leases project to date with the GASB Practice Fellow leading their leases project.
 - ✓ The Board tentatively agreed that based on Statement of Federal Financial Accounting Concepts (SFFAC) 5's definition of an asset and liability a federal entity's **right to use** a leased asset and the **obligation to make lease payments** are assets and liabilities of the entity.
 - ✓ All of the members agreed to explore the single-model approach as opposed to the dual-model approach.

Other Lease Discussions

- FASAB staff members met with OMB staff on April 30th to discuss budget scoring for capital leases. OMB staff explained that Appendix B of OMB Circular A-11, which provides instructions on the budgetary treatment of lease-purchases and leases of capital assets, is consistent with the scorekeeping rule developed by the executive (OMB) and legislative branches (CBO) originally in connection with the Budget Enforcement Act of 1990 (BEA). Statement of Financial Accounting Standards 13, issued by FASB, was the "support" for the scorekeeping rules developed. Because the lease budget scoring rules were developed in connection with the BEA and cannot be changed unless all of the scorekeepers (OMB, CBO, and the Budget Committees) agree, it is not likely that the rules will change based on potential changes in the financial accounting for leases. OMB staff provided other helpful insights which we will explore further later in the project.