GASB Preliminary Views

November 11, 2014

Comments Due: March 6, 2015

Preliminary Views

of the Governmental Accounting Standards Board

on major issues related to

Leases

Project No. 3-24P

LEASES

Notice of Public Hearings and Request for Written Comments

PUBLIC HEARINGS

Public hearings are scheduled as follows:

- **April 8, 2015, at the Sheraton LaGuardia East Hotel, New York City, NY**
- **April 9, 2015, at the Sheraton DFW Airport Hotel, Irving, TX**
- **April 10, 2015, at the Westin Los Angeles Airport, Los Angeles, CA**

The hearings are being held in combination with the public hearings on the Preliminary Views, *Financial Reporting for Fiduciary Responsibilities* (the Fiduciary Responsibilities Preliminary Views). The public hearings are scheduled to begin at 8:30 a.m. local time. Interested individuals or organizations may participate in a public hearing in person or by telephone. Details regarding participation will be provided after the GASB receives a notice of intent to participate.

**Deadline for written notice of intent to participate in the public hearings:
March 6, 2015**

Basis for public hearings. The GASB has scheduled the public hearings to obtain information from interested individuals and organizations about the issues discussed in this Preliminary Views and in the Fiduciary Responsibilities Preliminary Views. The hearings will be conducted by one or more members of the Board and its staff. Interested parties are encouraged to participate at the hearings and through written response.

Public hearing oral presentation requirements. Individuals or organizations that want to make an oral presentation in person or by telephone at a public hearing are required to provide, **by the deadline for notice of intent to participate (March 6, 2015),** a written notification of that intent and a copy of written comments addressing the issues discussed in this Preliminary Views. The notification and written submission should be addressed to the Director of Research and Technical Activities, Project No. 3-24P, and emailed to director@gasb.org or mailed to the address below. The notification should indicate a preference for participating in person or via telephone. A public hearing may be canceled if sufficient interest is not expressed by the deadline.

The Board intends to schedule all respondents who want to make oral presentations and will notify each individual or organization of the expected time of the presentation. The presentation may address issues discussed in this Preliminary Views, the Fiduciary Responsibilities Preliminary Views, or both documents. The time allotted each individual or organization will be limited to about 30 minutes for each document—10 minutes to summarize or elaborate on the written submissions, or to comment on the written submissions or presentations of others, and 20 minutes to respond to questions from those conducting the hearing.

Observers. Observers are welcome at the public hearings and are urged to submit written comments.

WRITTEN COMMENTS

Deadline for submitting written comments: March 6, 2015

Requirements for written comments: Any individual or organization that wants to provide written comments but does not intend to participate in a public hearing should provide those comments by **March 6, 2015.** Comments should be addressed to the Director of Research and Technical Activities, Project No. 3-24P, and emailed to director@gasb.org or mailed to the address below.

OTHER INFORMATION

Public files. Written comments and transcripts of the public hearings will become part of the Board's public file. Written comments also are posted on the GASB's website. Copies of the transcripts may be obtained for a specified charge.

Orders. This Preliminary Views may be downloaded from the GASB's website at www.gasb.org. For information on prices for printed copies, please contact the Order Department at the following address:

Governmental Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Telephone Orders: 1-800-748-0659

Please ask for our Product Code No. GV16.

GASB publications also may be ordered at www.gasb.org.

November 11, 2014

Comments Due: March 6, 2015

Preliminary Views

of the Governmental Accounting Standards Board

on major issues related to

Leases

Project No. 3-24P

GASB GOVERNMENTAL ACCOUNTING STANDARDS BOARD

CONTENTS

Page Numbers

Page
Numbers

Notice to Recipients of This Preliminary Views

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting that will (1) result in useful information for users of financial reports and (2) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards are designed to encourage broad public participation in the standards-setting process. As part of that due process, the GASB is issuing this Preliminary Views to solicit comments on the Board's proposal on leases.

This Preliminary Views is a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is *not* an Exposure Draft. A Preliminary Views is a Board document designed to set forth and seek comments on the Board's current views at a relatively early stage of a project. This document presents the Board's preliminary views on leases and related disclosures and discusses the concepts, purposes, and objectives of the Board's proposal. A Preliminary Views generally is issued when the Board anticipates that respondents are likely to be sharply divided on the issues or when the Board itself is sharply divided on the issues. The Board anticipates that respondents likely will express a range of differing views on major issues related to recognition and measurement by lessees and lessors and, therefore, it believes that a Preliminary Views, rather than an Exposure Draft, is appropriate. Although some Board members may disagree with certain aspects of the preliminary views and some may feel more strongly about certain provisions than others do, this Preliminary Views represents the Board's current views on the issues discussed in this document.

We invite your comments on all matters in this Preliminary Views. Respondents are requested to give their views only after reading the entire text of this Preliminary Views. Because guidance proposed in this Preliminary Views may be modified before it is issued as an Exposure Draft, it is important that you comment on any aspects with which you agree, as well as any with which you disagree. To facilitate our analysis of the responses to this Preliminary Views, it would be helpful if you explain the reasons for your views, including alternatives that you believe the GASB should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during deliberations leading to an Exposure Draft. Only after the Board is satisfied that all alternatives have adequately been considered, and modifications have been made as appropriate, will a vote be taken to issue an Exposure Draft. The Board also will seek and consider comments on the Exposure Draft before proceeding to a final Statement.

Summary

This document presents the preliminary views of the Governmental Accounting Standards Board on the issues associated with accounting for leases. These views are based on the foundational principle that all leases are financings of the right to use an underlying asset.

Definition of a Lease

A lease would be defined as a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction. Any contract that meets this definition would be accounted for under the leases guidance, unless specifically excluded. Leases that transfer ownership or contain a bargain purchase option would be accounted for as financed purchases and would not be accounted for under the leases guidance.

Contracts that contain both lease and service components generally would be separated so that each component is accounted for on its own. Contracts that contain leases of multiple assets may be separated in certain circumstances. Contracts entered into at or near the same time with the same counterparty would not be presumed to be part of the same lease unless there is evidence to the contrary.

Lease Term

The lease term would be defined as the period during which a lessee has a noncancellable right to use an underlying asset, plus the following, if applicable:

1. Periods covered by a lessee's option to extend the lease if it is probable, based on all relevant factors, that the lessee will exercise that option
2. Periods covered by a lessee's option to terminate the lease if it is probable, based on all relevant factors, that the lessee will not exercise that option.

Fiscal funding or cancellation clauses would continue to be disregarded for financial reporting purposes if the possibility of cancellation is remote. A government would reassess the lease term only if the lessee does one or both of the following:

1. Elects to exercise an option to extend the lease even though the government had previously determined that it was not probable that the lessee would do so
2. Does not elect to exercise an option to terminate the lease even though the government had previously determined that it was probable that the lessee would do so.

Lessee Accounting

Lessees would recognize a lease liability and an intangible lease asset at the beginning of a lease, unless it is a short-term lease as defined below. The liability would be measured at the present value of certain lease payments to be made over the lease term. The lease asset would be measured at the value of the lease liability plus any prepayments

and certain initial direct costs. A lessee would recognize interest expense on the lease liability and amortization expense on the lease asset. Disclosures would include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

Lessor Accounting

Lessors would recognize a lease receivable and a deferred inflow of resources at the beginning of a lease, unless it is a short-term lease as defined below. The receivable would be measured at the present value of certain lease payments to be received over the lease term. The deferred inflow of resources would be measured at the value of the lease receivable plus the amount of any payments received at or prior to the beginning of the lease that relate to future periods. A lessor would recognize interest revenue on the lease receivable and also would recognize revenue over the term of the lease from the deferred inflow of resources. A lessor would not derecognize the underlying asset in the lease. Disclosures would include a description of leasing arrangements, the total amount of revenue recognized from leases, and a schedule of future lease payments to be received.

Short-Term Lease Exception

A short-term lease would be defined as a lease that, at the beginning of the lease, has a maximum possible term under the contract, including any options to extend, of 12 months or less. A lessee in a short-term lease would not follow the regular accounting for leases but, instead, would recognize lease payments as expenses or expenditures based primarily on the payment terms of the contract. A lessor in a short-term lease would not follow the regular accounting for leases but, instead, would recognize lease payments as revenue based primarily on the terms of the contract.

Lease Terminations and Modifications

An amendment to a lease contract would be considered a modification unless the lessee’s right to use the underlying asset decreases, in which case it would be a partial termination. A lease termination would be accounted for by adjusting the balances of the lease liability and lease asset by a lessee, or the lease receivable and deferred inflow of resources by a lessor, with any difference being recognized as a gain or loss. A lease modification would be accounted for by adjusting the balances of the related lease liability and lease asset by a lessee, or the related lease receivable and deferred inflow of resources by a lessor. However, if the modification is due to the refunding of related debt, other guidance would apply.

Subleases and Leaseback Transactions

Subleases would be treated as transactions separate from the original lease. A government that has sublet an asset would recognize separately the liability and lease asset as lessee in the original lease and the receivable and deferred inflow of resources as lessor in the sublease. A sale-leaseback transaction would be accounted for under sale-leaseback accounting if there is a qualifying sale. In that case, the sale would be accounted for as any other sale, except any gain or loss would be reported as a deferred inflow of resources or a deferred outflow of resources and recognized over the term of the leaseback. The leaseback would be accounted for in the same manner as any other lease. A lease-leaseback transaction would be recognized as a net lease liability or lease receivable, with disclosure of the gross lease liability and lease receivable.

Leases with Related Parties and Intra-Entity Leases

A lease between related parties would continue to be recognized based on the substance instead of the form of the transaction. Leases within financial reporting entities would continue to be treated like any other transaction between component units. Leases with blended component units would be eliminated in the financial statements of the reporting entity, while leases with discretely presented component units would be presented separately from other leases.

How the Changes Proposed in This Preliminary Views Would Improve Financial Reporting

The Board's proposed requirements in this Preliminary Views, if ultimately issued as a Statement, would provide updated guidance that is based specifically on issues applicable to state and local governments. Financial statement users would receive enhanced decision-useful information about the effects of leases on a government's financial statements. The Board believes that the accounting and financial reporting guidance on leases would be less complex for practitioners. It would provide greater comparability as a single approach would be applied to accounting for leases. It also would provide meaningful simplification compared to the existing complex guidance. The Board considered expected benefits and costs when deliberating the issues and alternatives related to accounting for leases.

CHAPTER 1—OBJECTIVE AND BACKGROUND

Objective of the Leases Project

1. The objective of the Leases project is to reexamine issues associated with accounting and financial reporting for leases and consider improvements to existing guidance. Specifically, the project seeks to answer the following questions:

a. Are current accounting and financial reporting standards, including the distinction between types of leases, appropriate to meet essential user needs for decision-useful or accountability information regarding governmental leases?
b. If current standards are not considered adequate, what other requirements should be considered?

Project Background

2. Current authoritative guidance on lease accounting is provided by National Council on Governmental Accounting (NCGA) Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments;* GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases;* GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements;* and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Statement 62 incorporated the provisions of Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases,* as amended and interpreted through November 30, 1989, into the GASB's authoritative literature.

3. Part of the GASB's strategic plan is to evaluate the effectiveness and impact of existing standards that have been in effect for a sufficient length of time. NCGA Statement 5 was issued in 1982 and GASB Statement 13 in 1990. While GASB Statement 62 was issued in 2010, the guidance it contained predated November 30, 1989.

4. Under current authoritative literature, leases are classified as either capital or operating, based on a set of criteria that has been criticized for allowing the opportunity to structure lease agreements so that they are classified as operating leases. Capital leases lead to the reporting of long-term liabilities for lessees, while operating leases do not. Many leases entered into by governments are reported as operating leases. Even though operating leases represent long-term commitments to make payments when governments are lessees, no liabilities are recognized, although there are disclosures of the obligations in the notes to the financial statements. Likewise, no assets are recognized when governments are lessors and have long-term rights to receive operating lease payments. In Concepts Statement No. 4, *Elements of Financial Statements*, the Board established definitions of assets and liabilities. This project provides an opportunity for the Board to apply those definitions and reconsider whether assets and liabilities arise from operating lease arrangements.

5. The FASB and International Accounting Standards Board (IASB) have current projects that propose to replace leases guidance for nongovernmental entities. Because of the existing similarities between private-sector and public-sector leasing guidance and the potentially significant changes of the FASB and IASB projects, the GASB has received technical inquiries regarding how these changes may affect accounting for leases by state and local governments.

6. The GASB's Leases project is being undertaken during the final stages of the FASB and IASB projects in order to maximize efficiency and timeliness, where possible. The timing of the lease accounting project provides the opportunity to monitor the progress of the FASB and IASB projects to assess, on a contemporaneous basis, the proposed new or amended leasing guidance in the context of the state and local government environment. The FASB and the IASB are expected to issue final pronouncements in 2015. The GASB project provides an opportunity to reassess the existing GASB guidance, as well as consider improvements contemplated by the FASB and IASB projects in the context of the unique nature of governmental entities and the complexities of their leasing transactions.

7. Pre-agenda research on leases began in April 2011. The focus of the research during that time primarily was on monitoring developments in the FASB and IASB projects. Based on those developments, a project prospectus was discussed with the Board in April 2013. At that time, the project was moved to the Board's current technical agenda. Deliberations began in August 2013.

8. A task force composed of 13 persons broadly representative of the GASB's constituency was appointed in 2013. The task force members provided feedback on issues discussed in the Leases project, primarily through a meeting with the GASB held in January 2014, periodic conference calls, and review of draft documents. In addition, further feedback was sought from members of the Governmental Accounting Standards Advisory Council at its meetings. The GASB also held a joint meeting with the Federal Accounting Standards Advisory Board in March 2014 to discuss matters of mutual interest with respect to leasing in the governmental environment.

Objective of This Preliminary Views

9. The objective of this Preliminary Views is to present the Board's current views on what it believes are the most fundamental issues related to lease accounting in order to solicit comments from constituents. Those comments will be considered by the Board in its deliberations, which may lead to issuance of proposed standards. This Preliminary Views does not address effective date or transition provisions. The Board intends to deliberate those topics before issuing an Exposure Draft of a proposed Statement for public comment.

Foundational Principle

10. The preliminary views described in this document are based on the Board's belief that all leases are financings of the right to use an underlying asset and, therefore, a single approach would be applied to accounting for leases. This approach would be less complex than the current model, which requires lessees to classify leases as either capital or operating and requires lessors to classify leases as either sales-type, direct financing, or operating.

Considerations Related to Benefits and Costs

11. One of the principles guiding the Board's setting of standards for accounting and financial reporting is the assessment of expected benefits and perceived costs. The Board strives to determine that its standards address a significant user need and that the costs incurred through the application of its standards, compared with possible alternatives, are justified when compared to the expected overall public benefit. The Board considered expected benefits and costs when deliberating the issues and alternatives related to accounting and financial reporting for leases. For example, the provisions for a short-term lease exception are included in this Preliminary Views because of cost concerns.

12. The Board believes that the provisions in this Preliminary Views would enhance the consistency and comparability of the reporting for leases. The changes being proposed would provide users with information to better assess the nature and extent of a government's leasing activities and the impact of those activities on the financial statements. The changes being proposed also would provide preparers and auditors with less complex guidance to follow when reporting leases. The Board does not believe at this time that the proposed changes will result in a significant increase in costs; however, the costs of reporting leases have not been fully assessed. Therefore, a field test will be performed during the comment period of the Preliminary Views to gather information relative to the costs of reporting leases in accordance with the provisions therein.

CHAPTER 2—APPLICABILITY AND SCOPE

1. This chapter describes the Board's preliminary views regarding the applicability and scope of the proposed guidance contained in this document. It presents the Board's tentative definition of a lease and discusses whether certain types of arrangements are in the scope of this Preliminary Views.

2. This chapter also presents the Board's preliminary views regarding contracts containing multiple components and combinations of contracts with the same counterparty. Current guidance on leases is silent with respect to these topics.

Applicability

3. The provisions included in this Preliminary Views would be applied to financial statements of all state and local governments. These provisions include guidance for both governmental lessees and governmental lessors.

Definition of a Lease

4. **The Board's preliminary view is that a lease is a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like[1] transaction.**

5. The Board believes that this definition of a lease would provide sufficient guidance for determining what transactions should be accounted for as leases. A contract indicates a legally enforceable arrangement, whereas the term *agreement* that is used in the current definition is not as strong. The current definition specifies the use of a capital asset. While many leases involve capital assets, using the phrase *nonfinancial asset* allows for the possibility that another type of asset could be subject to a lease. However, stating that the asset should be nonfinancial would exclude securities lending and other types of transactions involving financial assets from the leases guidance.

6. Specifying that a lease is an exchange or exchange-like transaction would exclude arrangements in which the consideration exchanged is nominal (nonexchange transactions). The Board believes that the substance of those arrangements is something other than a lease; they may be contributions or grants. The existing guidance on nonexchange transactions would be applied in those cases.

[1]The scope of this Preliminary Views includes both exchange and exchange-like transactions. The difference between exchange and exchange-like transactions is a matter of degree. In contrast to a "pure" exchange transaction, an exchange-like transaction is one in which (a) the values exchanged, though related, may not be quite equal or (b) the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition.

Scope

7. **The Board's preliminary view is that any contract that meets the definition of a lease should be subject to the guidance in this document, unless the contract meets one of the specific scope exceptions below.** Regardless of the label used to identify a contract, if it meets the definition of a lease in paragraph 4 of this chapter, it would be within the scope of this Preliminary Views. However, not every arrangement referred to as a lease would be reported as a lease for financial reporting purposes. For instance, contracts that do not transfer the right to use an asset from one contracting party to the other, even if they are called leases, would not meet the definition of a lease and therefore would not be included within the scope of this guidance. The substance of the arrangement, evaluated based on the definition of a lease, would govern the accounting and financial reporting treatment, regardless of the name given to it.

8. Current guidance excludes several types of transactions from its scope. The Board was not aware of any compelling reasons to change any of the existing scope exceptions and therefore believes that these exceptions should remain in place. **The Board's preliminary view is that the following should be excluded from the guidance for leases**:

a. **Lease contracts concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and similar nonregenerative resources**
b. **Leases of biological assets, including timber**
c. **Licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights**
d. **Contracts that meet the definition of a service concession arrangement in Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements.***

9. **The Board's preliminary view is that contracts that transfer ownership of the underlying asset, and do not contain termination options, should be reported as financed purchases of that asset. Leases that contain a bargain purchase option should be reported in the same manner.**

Contracts with Multiple Components

10. **The Board's preliminary view is that a contract that contains both lease and service components generally should be separated so that each component is accounted for on its own.** If a government enters into a lease contract (such as the right to use a building) and a service contract (such as maintenance and landscaping services for that building), the contracts would be accounted for separately under the respective guidance for each type of transaction. Sometimes the lease and service arrangements are included in the same contract. The Board believes that the accounting and financial reporting should not be different simply because the lease and service are included in one contract. The Board recognizes that separating components of a contract may be difficult, especially for lessees, and particularly when there is a single element of consideration that covers all components. As a result, an exception provision to the proposed separation

requirement when measurement is not practical has been provided. (See paragraph 13 of this chapter.) However, in most cases, governments would be required to separate components. There would not be an accounting policy election to account for the entire contract as one lease. The Board believes this would enhance comparability between governments and would result in financial reporting that better represents the nature of the transaction.

11. **The Board's preliminary view is that a contract that contains multiple lease components that have different lease terms should be separated so that each component is accounted for on its own. Additionally, lessees should separate multiple lease components when the underlying assets are in different major classes of assets.** A government may enter into a contract that includes leases of multiple assets. Each asset that is leased would be a lease component. The Board believes that multiple lease components generally should be separated for the same reasons that lease components should be separated from service components; that is, they should be separated if the accounting for each piece would be different had they not been included in the same contract. However, the financial statement effects of two leases of the same class of asset for the same length of time would be the same whether the two leases were in one contract or two separate ones. Therefore, separation would be undertaken only when (a) the lease terms (as defined in Chapter 3) differ or (b) the underlying assets are in different classes for disclosure purposes (as discussed in Chapter 4 for lessees). A lessor would not be required to separate multiple lease components if the underlying assets are in different major classes because the reported amount of a lessor's assets under lease does not depend on the consideration received for the lease.

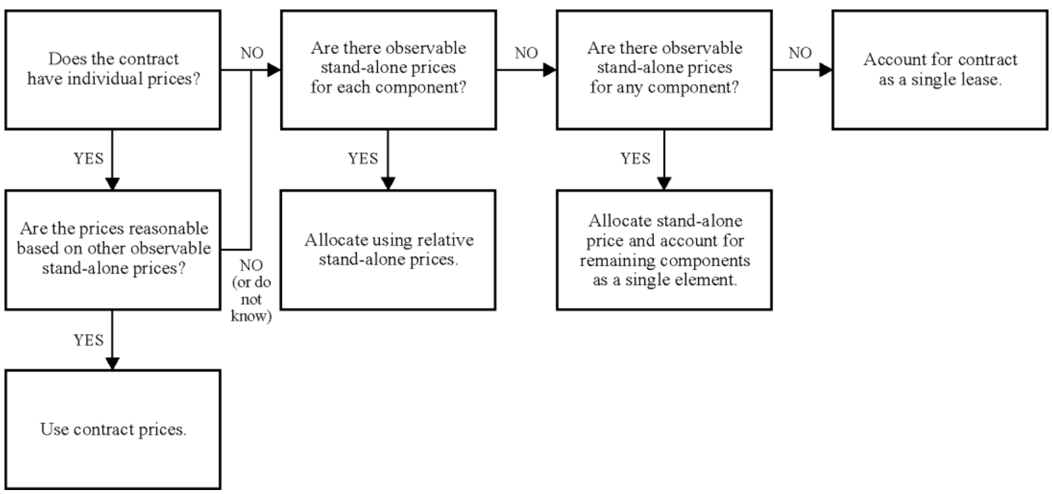
12. To separate components of a contract, a government would identify the components and assign consideration required under the contract to each one. The Board believes that each asset being leased is a lease component, and each contracted service is a service component. To assign consideration to the different components, a government would first use any prices for individual components that are included in the contract, if they are reasonable based on observable stand-alone prices, for (a) leasing the same or similar assets or (b) contracting for the same or similar services. Stand-alone prices are those that would be paid or received if those assets were leased or services were contracted individually. However, the provision that these prices should be reasonable is intended to minimize the effect of a component price artificially being inflated or deflated, thereby shifting expenses to one component or another. Some agreements provide discounts for bundling multiple leases or services together in one contract. These discounts may be taken into account when determining if the individual component prices are reasonable. For example, if the individual component prices are each discounted by the same percentage from normal market prices, those component prices could be considered reasonable.

13. If a contract does not include prices for individual components, or if some of those prices are not reasonable based on observable stand-alone prices, a government would do the following:

a. If observable stand-alone prices are available for all components, the government would allocate the consideration based on the relative values of the observable stand-alone prices.
b. If observable stand-alone prices are available for some (but not all) components, the government would allocate the observable stand-alone price to each component for which it is available. The remaining components would be accounted for as a single unit, with the remaining consideration allocated to that unit.
c. If observable stand-alone prices are not available for any of the components, the entire contract would be accounted for as a single lease unit.

In all steps of this process, the government would consider observable stand-alone prices that are for identical or similar assets or services. The steps for allocation of consideration are illustrated in the following flowchart.

Flowchart for Allocation of Consideration to Multiple Components



14. The Board believes that allocation of consideration should be based on the relative prices of each component. However, there may be circumstances in which determining the stand-alone price of each component is difficult. For example, a particular asset being leased may rarely be leased without an accompanying service contract. Another example is leasing a unique asset such that there are no comparable transactions to observe. In those situations, the Board believes that the costs to estimate the stand-alone prices would outweigh the benefits. In such circumstances, multiple component contracts may be accounted for as one lease, even though the accounting result may not be the same as if the components were covered by separate contracts.

15. When multiple components are accounted for as a single unit (under paragraph 13b or 13c above), accounting for that unit would be based on the primary lease component within that unit. Therefore, determination of the lease term for purposes of calculating the lease liability and major class of the underlying asset for disclosure purposes would be based on that component. The Board expects that the primary lease component generally would be evident based on the terms of the contract.

Contract Combinations

16. **The Board's preliminary view is that governments should presume that contracts entered into at or near the same time with the same counterparty are not part of the same lease unless there is evidence to the contrary.** Governments may enter into multiple contracts at or near the same time with the same counterparty. These contracts might be related to each other and might have been negotiated as one agreement; however, the presumption would be that they are not. Nevertheless, if certain criteria are met, these contracts would be accounted for as if they were one contract. This would require governments to identify contracts entered into at or near the same time with the same counterparty in order to determine if the criteria that follow in paragraph 17 are met. Many governments have procurement processes by which leases and related services are negotiated separately, even if the same counterparty is awarded the contract for both. Additionally, under the presumption that such contracts are not part of the same lease, governments would not be burdened with the combination, and likely the multiple component allocation, unless circumstances indicate that it would be appropriate.

17. Contracts would be considered part of the same lease, and subject to combination for accounting purposes, if either of the following criteria is met:

a. The contracts are negotiated as a package with a single objective.
b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

The Board believes meeting either of these criteria would indicate that the substance of the contracts is a single lease and, therefore, the contracts should be accounted for as such.

18. Evidence of the criterion in paragraph 17a could be found through the procurement process. For example, a series of one-year leases for the same asset with consecutive lease terms would be considered a single long-term lease. The criterion in paragraph 17b would be evident from the language of the contracts. A single arrangement involving a lease and a service would be subject to the guidance on multiple components and allocation of consideration discussed in paragraphs 10–15 of this chapter. While this may result in the same accounting treatment as if the contracts had not been combined, the allocation to multiple components would normalize any disproportionate prices between the two contracts.

CHAPTER 3—LEASE TERM

1. This chapter presents the Board's preliminary views regarding the lease term, which is the period during which the lease contract will be in effect. This chapter discusses (a) the definition of *lease term* and (b) the circumstances in which a government would reassess the lease term. These provisions would apply to both lessees and lessors. The definition of the lease term is an important factor in the measurement of a lessee's lease liability (Chapter 4) and a lessor's lease receivable (Chapter 5).

Definition of the Lease Term

2. **The Board's preliminary view is that the lease term should be defined as the period during which a lessee has a noncancellable right to use an underlying asset (referred to as the noncancellable period), plus the following, if applicable:**

a. **Periods covered by a lessee's option to extend the lease if it is probable,[2] based on all relevant factors, that the lessee will exercise that option**
b. **Periods covered by a lessee's option to terminate the lease if it is probable, based on all relevant factors, that the lessee will not exercise that option.**

The Board believes that including periods covered by renewal or termination options based on some likelihood of their occurrence would better capture the economic substance of a lease transaction. A period covered by an option would be included in the lease term only when it is *probable* that the lease will include that period, which is consistent with the primary threshold used for recognizing a liability for a loss contingency. The Board also believes that using a consistent definition of lease term for both lessees and lessors would be beneficial for governments that operate on each side of the transaction.

3. The lease term would be determined the same way for both the lessee and the lessor and should start with the noncancellable period. This is the time during which the lessee is legally obligated to make payments to the lessor. If only the lessor has an option to terminate or cancel the lease after a certain point in time, or if the lessee and lessor both have that option, any periods following that date would be considered cancellable periods and would be excluded from the lease term. Neither the lessee nor the lessor would have an enforceable obligation against the other party for those cancellable periods. However, if only the lessee has an option to terminate the lease, the option would be evaluated under paragraph 2b of this chapter because the lessee can enforce the contract against the lessor, at the lessee's discretion.

4. The Board believes that, to help determine whether periods covered by renewal or termination options should be included in the lease term, a government should assess qualitative and quantitative factors relevant to the likelihood that the lessee will exercise those options. These factors would be considered by both the lessee and the lessor. The negotiations leading to the lease agreement could inform the lessor about the lessee's

---

[2]The term *probable* is defined in paragraph 100 of Statement 62 as "likely to occur" and is used in the same sense in this paragraph.

circumstances and expectations. Examples of factors to consider include, but are not limited to, the following:

a. A significant economic incentive, such as contractual terms and conditions for the optional periods that are favorable compared with current market rates
b. The lessee's history of exercising renewal or termination options
c. The extent to which the lease is essential to the provision of a government's services
d. A significant economic disincentive, such as costs relating to terminating the lease and signing a new lease (for example, negotiation costs, relocation costs, abandonment of significant leasehold improvements, costs of identifying another suitable underlying asset, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location).

5. Many governmental lease contracts include fiscal funding or cancellation clauses. These clauses allow governmental lessees to terminate a lease agreement, typically on an annual basis, if the government does not appropriate funds for the lease payments. Many times, laws or regulations require inclusion of a fiscal funding or cancellation clause, but the government does not intend or expect to exercise it. For this reason, existing leases guidance provides that fiscal funding or cancellation clauses should be disregarded for accounting purposes if the possibility of cancellation is remote. The existing guidance results in accounting for the economic substance of the transaction over its legal form. **The Board's preliminary view is that fiscal funding or cancellation clauses should continue to be disregarded for financial reporting purposes if the possibility of cancellation is remote.**

Reassessments of the Lease Term

6. **The Board's preliminary view is that a government should reassess the lease term only if the lessee does one or both of the following:**

a. Elects to exercise an option to extend the lease even though the government had previously determined that it was not probable that the lessee would do so
b. Does not elect to exercise an option to terminate the lease even though the government had previously determined that it was probable that the lessee would do so.

7. A government would reassess the lease term, and therefore remeasure the lease liability or lease receivable, when there is a change in the period during which the lease contract will be in effect. While the initial determination of a lease term would involve an assessment of qualitative factors and an application of probability, the Board believes that the costs of performing this assessment regularly would outweigh the benefits of any resulting updated measurements. Additionally, many lessors do not have ready access to information about changes in the lessee's circumstances. However, the Board also believes that the lease term should be updated when there is a known event that changes

the initial determination. The proposed requirement in paragraph 6 would impose less of a burden on preparers because there would be little or no judgment involved or ongoing reassessments to make. Both lessees and lessors would know whether an option has been exercised and therefore would be in a position to reassess the lease term.

CHAPTER 4—LESSEE ACCOUNTING

1. This chapter presents the Board's preliminary views on accounting by governments in their capacity as lessees. It discusses recognition and measurement issues, as well as potential disclosure requirements.

Recognition and Measurement for Lessees

2. **The Board's preliminary view is that lessees should recognize a lease liability and an intangible lease asset at the beginning of a lease, unless it is a short-term lease.** (The accounting for short-term leases is discussed in Chapter 6.) At the beginning of a lease, the lessor makes the underlying asset available to the lessee by, for example, physically delivering a piece of equipment or providing access to a building. In those cases, the lessor has given the lessee the contractual right to use the asset. The Board believes that the lessor relinquishing the right to use the underlying asset in exchange for the lessee's contractual agreement to make payments constitutes an exchange transaction that should be recognized in financial statements.

3. The Board believes that the lessee's right to use the underlying asset meets the definition of an asset. Assets are defined in paragraph 8 of Concepts Statement 4 as "resources with present service capacity that the government presently controls." The right to use an underlying asset enables a lessee government to provide services using that asset (present service capacity), and the lessee government has contractual rights to control the use of that right (present control). The Board also believes that the right to use an underlying asset meets the definition of an intangible asset in Statement No. 51, *Accounting and Financial Reporting for Intangible Assets.*[3] That Statement provides that an intangible asset is an asset that lacks physical substance, is nonfinancial in nature, and has an initial useful life extending beyond a single reporting period. The intangible lease asset (hereinafter referred to as the lease asset) that would be recognized meets all of those characteristics.

4. The Board believes that the lessee's obligation to provide consideration to the lessor (usually in the form of lease payments) meets the definition of a liability. Liabilities are defined in paragraph 17 of Concepts Statement 4 as "present obligations to sacrifice resources that the government has little or no discretion to avoid." The obligation to make the payments required under a lease is created when the contract is executed, typically when the lessor makes the underlying asset available. The lessee has little or no discretion to avoid making those payments without a modification of the lease contract.

5. Under this preliminary view, a lessee would recognize a lease asset and liability for all leases other than short-term leases. As described in the foundational principle in Chapter 1, the Board believes that all leases are financings of the right to use an underlying asset and, therefore, should be accounted for as such. The Board also believes

[3]The provisions of Statement 51 do not apply to leases. However, there may be assets that meet the characteristics of intangible assets as provided in that Statement but follow other recognition and measurement guidance.

that having a single approach to financial reporting for leases would improve comparability and reduce opportunities to structure leases to achieve a certain accounting treatment.

6. The existing guidance for lessees regarding accounting for leases in governmental funds (found in NCGA Statement 5, as amended) would remain in effect. Under that guidance, a lessee would recognize an expenditure (a capital outlay, representing the acquisition of the right of use) and an other financing source (to recognize the financing aspect of the lease agreement) at the beginning of a lease, applying the measurement guidance set forth in the following section.

Reporting the Lease Liability

7. A lessee would measure the lease liability initially at the present value of payments to be made for the lease term (as defined in paragraph 2 of Chapter 3). Measurement of the lease liability would include the following types of payments that might be required by a lease:

a. Fixed payments, less any lease incentives (such as a cash payment or reimbursement of moving costs) receivable from the lessor
b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate in effect at the beginning of the lease
c. Variable lease payments that are in-substance fixed payments (described in paragraph 9 of this chapter)
d. Amounts that are probable of being required to be paid by the lessee under residual value guarantees
e. The exercise price of a nonbargain purchase option if it is probable that the lessee will exercise that option
f. Payments for penalties for terminating the lease if it is probable that the lessee will exercise an option to terminate the lease
g. Any other payments that are probable of being required based on an assessment of qualitative factors. Variable payments based on future performance of the lessee or usage of the underlying asset should not be included but, rather, recognized as an expense or expenditure in the resource flows statements in the period in which the obligation for those payments is incurred.

8. The Board believes that the types of payments listed in paragraph 7 are appropriate to include in the initial measurement of a lease liability because the likelihood of their being paid is probable. Some of these, such as fixed payments, are certain of being paid. The lease payments that have uncertainty (such as nonbargain purchase options and termination penalties) would be treated as contingencies. Statement 62 provides that a contingency should be recognized as a liability if it is probable that the liability has been incurred and the amount can be reasonably estimated. In many cases, the amount would be determinable from the provisions of the lease and, therefore, inclusion in the lease liability would be based on the assessment of the likelihood of these payments.

9. The Board believes that variable payments that are based on the lessee's performance or usage (for example, volume of sales or number of machine hours used) should not be included in the liability, even if they are probable of being paid, because estimating these amounts may not be practical. These payments would be recognized as an expense or expenditure in the period to which they relate. However, variable payments that are in-substance fixed payments would be included in the liability. An example would be a lease payment based on a percentage of sales but with a minimum amount to be paid. That minimum amount would be an in-substance fixed payment.

10. The future lease payments would be discounted using the rate the lessor charges the lessee. The Board believes that this is appropriate because it is the rate at which the transaction is made. However, if that rate cannot be readily determined by the lessee, the lessee would be permitted to use its own incremental borrowing rate. This would provide an acceptable alternative for situations in which a lessee does not have enough information to determine the rate the lessor is charging.

11. At subsequent financial reporting dates, the lessee would calculate the amortization of the discount on the liability and report that amount as interest expense (or expenditure, as appropriate) for the period. Any payments made would be allocated first to the accrued interest expense and then to the lease liability. In the governmental funds, payments would be allocated first to debt service interest expenditure and then to debt service principal expenditure. This treatment is consistent with any long-term liability for which interest is imputed.

12. At subsequent financial reporting dates, the lessee would consider remeasurement of the lease liability if any of the following have occurred, unless the result of the change is not expected to be significant:

a. There is a change in the lease term.
b. There is a change in the index or rate used to determine variable lease payments.
c. An assessment of qualitative factors indicates that the likelihood of a residual value guarantee being paid has changed from probable to not probable, or vice versa.
d. An assessment of qualitative factors indicates that the likelihood of a nonbargain purchase option being exercised has changed from probable to not probable, or vice versa.
e. There is a change in the amounts that are probable of being paid.
f. There is a change in the rate the lessor charges the lessee.

These changes would impact either the amount of payments to be made or the amount of interest expense to be recognized, or both. Therefore, it is appropriate that the lessee consider if remeasurement is necessary to reflect those changes.

13. At subsequent financial reporting dates, the lessee would consider reassessment of the discount rate used to measure the lease liability if any of the following have occurred:

a. There is a change in the lease term.

b. The result of a change in the index or rate used to determine variable lease payments is expected to be significant.
c. An assessment of qualitative factors indicates that the likelihood of a nonbargain purchase option being exercised has changed from probable to not probable, or vice versa.

These changes would alter the character of the lease such that the discount rate implicit in the lease would be different. If the lessee uses the discount rate implicit in the lease to measure its lease liability (rather than its incremental borrowing rate), it would be appropriate to remeasure the lease liability using a revised rate. If the lessee uses its incremental borrowing rate, reassessment of that rate also would be appropriate because the incremental rate may be different under certain circumstances.

Reporting the Lease Asset

14. A lessee would initially measure the lease asset as the sum of the following:

a. The amount of the initial measurement of the lease liability (see paragraph 7 of this chapter)
b. Lease payments made to the lessor at or before the beginning of the lease, less any lease incentives received from the lessor
c. Initial direct costs that are ancillary charges necessary to place the asset into service.

15. The Board believes that measuring the lease asset based on the amount of the lease liability is consistent with the requirement to measure a capital asset at historical cost. Payments made prior to the measurement of the liability also would be included in the cost of the asset. Ancillary charges necessary to place an asset into service would be capitalized as they would be for any other capital asset under paragraph 18 of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* The Board differentiated these costs from debt issuance costs, as described in paragraph 12 of Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt.* Debt issuance costs would be recognized as an expense or expenditure of the period in which they are incurred, as required by paragraph 15 of Statement 65. The Board believes that governments would be able to differentiate the various initial direct costs associated with a lease by considering how those costs would be treated in the financed purchase of a capital asset.

16. The lease asset generally would be amortized in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. This would be the case even if the underlying asset is a nondepreciable asset, such as land. The amortization would represent the use of the service capacity of the right to use the underlying asset, which generally occurs through the passage of the time for which that right is granted. The amortization of the lease asset would be reported as amortization expense, which may be combined with depreciation expense related to other capital assets for financial reporting purposes.

17. However, if the lease contains a nonbargain purchase option that the lessee has determined is probable of being exercised, the lease asset would be amortized over the useful life of the underlying asset. In this case, the lessee expects to purchase the underlying asset itself and, therefore, would depreciate the underlying asset as if it were owned from the outset. If that purchase option is probable of being exercised and the underlying asset is not depreciable, the lease asset would not be amortized.

18. If the lease asset meets the definition of an investment, as proposed in the Exposure Draft, *Fair Value Measurement and Application*, a lessee would follow the accounting guidance for investments. With respect to a lease asset that is an investment, the Board believes that consistent treatment of investments is more important than following the leases guidance.

19. If a lease liability is remeasured in accordance with paragraphs 12 and 13 of this chapter, the corresponding lease asset generally would be remeasured by the same amount. The Board believes that most changes to the lease liability would result in a change in the amount the lessee is paying for its intangible asset; this is a change in an estimate. However, if the remeasurement of the lease liability results from a change in an index or rate that is attributable to the current period, the change should be reported in the resource flows statements for the period. If the carrying value of the lease asset has been reduced to zero, any further remeasurement of the liability should be reported in the resource flows statements.

20. The lease asset, as an intangible asset, would be subject to the impairment guidance in Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* Because of the relationship between the underlying asset in a lease and the right to use that asset, the presence of impairment indicators (described in paragraph 9 of Statement 42) with respect to the underlying asset may result in a change in the manner or duration of use of the lease asset. The change in the manner or duration of use of the lease asset would be an indicator that the lease asset may be impaired. The period during which the underlying asset is less usable would be the relevant factor in determining the magnitude of the decline in service utility of the lease asset. For example, if a leased building is rendered unusable by a natural disaster, the amount of time that the lessee cannot use the building would be a change in the duration of use of the lease asset. If a lease asset is determined to be impaired, it would be adjusted first for any change in the corresponding lease liability (for example, a waiver or reduction in the lease payments during the period in which the underlying asset cannot be used), with any remaining adjustment being recognized as an impairment loss.

21. The Board acknowledges that the provisions described in this chapter could be burdensome for preparers, especially those with a large number of lease contracts. The Board considered suggestions to propose a capitalization threshold or an exception for leases of individually small items. However, the Board believes that these are specific applications of the general provision in all GASB pronouncements that guidance does not need to be applied to immaterial items. The use of a capitalization threshold would be a matter of accounting policy for each government based on its facts and circumstances, consistent with treatment of other long-lived assets.

Disclosures for Lessees

22. **The Board's preliminary view is that a lessee should disclose the following about its lease activities:**

a. A general description of its leasing arrangements, including:
   (1) The basis, terms, and conditions on which variable lease payments not included in the lease liability are determined
   (2) The existence, terms, and conditions of residual value guarantees provided by the lessee

b. The total amount of assets recorded under leases, and the related accumulated amortization, to be disclosed separately from owned assets

c. The amount of assets recorded under leases by major classes of assets underlying its lease assets

d. The amount of expense recognized for the period for variable lease payments not previously included in the lease liability

e. The amount of expense recognized for the period for other payments, such as residual value guarantees or penalties, not previously included in the lease liability

f. A schedule of future lease payments to be made in each of the subsequent five years and in five-year increments thereafter, with reconciliation to the lease liability for the discount (that represents interest)

g. Commitments under leases (other than short-term leases) that have not yet begun

h. The components of any net impairment loss (gross impairment loss less change in lease liability) recognized on the lease asset during the period.

A lessee would not be required to disclose collateral pledged for a lease (under paragraph 113 of Statement 62) if that collateral is solely the asset underlying the lease.

23. The Board believes that the disclosures in paragraph 22 would provide financial statement users with essential information regarding a government's leasing activities as a lessee. The Board also believes that the perceived benefits of these disclosures outweigh their expected costs. Several of these disclosures are, in fact, already required by current standards.

24. The Board considered a variety of potential disclosures and decided not to propose certain additional disclosures, for example, the amount of interest expense recognized that relates to leases and the discount rate used to measure lease liabilities. The Board believes that these additional disclosures would not be essential information for users of governmental financial statements.

CHAPTER 5—LESSOR ACCOUNTING

1. This chapter presents the Board's preliminary views on accounting by governments in their capacity as lessors. It discusses recognition and measurement issues, as well as potential disclosure requirements.

Recognition and Measurement for Lessors

2. **The Board's preliminary view is that lessors should recognize a lease receivable and a deferred inflow of resources at the beginning of a lease, unless it is a short-term lease.** (The accounting for short-term leases is discussed in Chapter 6.) Recognition of a deferred inflow of resources, rather than a liability, is based on the view that a lessor has no further performance obligation under the lease after the lessor has made the underlying asset available to the lessee at the beginning of the lease. (Service and other financial and performance obligations would be separated under the multiple component guidance in Chapter 2.) Therefore, the lessor has a contractual right to receive lease payments—a receivable that meets the definition of an asset in Concepts Statement 4—even though those payments are applicable to future periods (a deferred inflow of resources). Any initial direct costs incurred by the lessor would be reported as an expense or expenditure of the period. This proposed requirement is consistent with treatment of such costs in Statement 65. As described in the foundational principle in Chapter 1, the Board believes that all leases are financings and having a single approach to accounting for leases (other than short-term) would be less complex than the current model.

3. The existing accounting guidance for leases in governmental funds would remain in effect. Under that guidance, found in NCGA Statement 5, as amended, a lessor would recognize a lease receivable, and a deferred inflow of resources for the portion of the receivable that is not available (as defined for governmental funds). A lessor would follow the measurement guidance in the following sections in this chapter. The Board believes that, based on the current financial reporting model, there is no reason for lease receivables to be accounted for differently than other receivables reported in governmental funds.

Reporting the Lease Receivable

4. A lessor would measure the lease receivable initially at the present value of lease payments to be received for the lease term (as defined in paragraph 2 of Chapter 3), reduced by any provision for uncollectible amounts. Measurement of the lease receivable would include the following types of payments that might be required by a lease:

a. Fixed payments
b. Variable payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the beginning of the lease
c. Portions of variable payments that are in-substance fixed payments (described in paragraph 5 of this chapter)

d. Residual value guarantees that are in-substance fixed payments (described in paragraph 5 of this chapter).

5. The Board believes that the types of payments listed in paragraph 4 are appropriate to include in the initial measurement of a lease receivable because they are reasonably assured of being collected. For example, a payment may vary based on performance or usage but have a minimum amount that is required to be paid. The minimum amount is in substance a fixed payment. Similarly, a residual value guarantee would be an in-substance fixed payment if it stipulates the underlying asset will be sold at the end of the lease term, with the lessee taking responsibility for any shortfall if the sales price is less than an agreed-upon minimum amount. In any instance, the lessor is guaranteed to receive cash payments of that price.

6. The Board believes that certain other types of lease payments should not be included in the initial measurement of the lease receivable. Variable payments that are based on the lessee's performance or usage (for example, volume of sales or number of machine hours used) would not be included in the receivable because estimating these amounts may not be practical. Those payments represent a contingent gain from a lessor's perspective, and recognition would be inconsistent with the guidance on gain contingencies in Statement 62. Those payments would be recognized as revenue in the period to which they relate.

7. Amounts to be received under residual value guarantees (that are not in-substance fixed) would be recognized as a receivable and revenue when a guarantee payment is required (as agreed to by the lessee and lessor) and the amount can be reasonably estimated. Amounts to be received for the exercise price of a nonbargain purchase option or penalties for lease termination would be recognized as a receivable and revenue when those options are exercised. This treatment is consistent with the guidance on gain contingencies in Statement 62.

8. The future lease payments to be received would be discounted using the rate the lessor charges the lessee, which may be a rate implicit in the lease if it is not specifically stated. The Board believes that this is appropriate because it is the rate incorporated in the transaction. The Board also believes that the lessor would have the information to determine this rate and, therefore, no alternate rate (such as the lessee's incremental borrowing rate) would be allowed for lessors.

9. At subsequent financial reporting dates, the lessor would calculate the amortization of the discount on the receivable and report that amount as interest revenue for the period. Any payments received would be allocated first to the accrued interest revenue and then to the lease receivable. This treatment is consistent with any long-term receivable for which interest is imputed, as described in paragraphs 185 and 186 of Statement 62.

10. At subsequent financial reporting dates, the lessor would consider remeasurement of the lease receivable if any of the following have occurred, unless the result of the change is not expected to be significant:

a. Change in the lease term

b. Change in the index or rate used to determine variable lease payments
c. Change in the rate the lessor charges the lessee.

These changes would significantly impact either the amount of payments to be received or the amount of interest revenue to be recognized or both amounts. Therefore, it is appropriate that the lease receivable be remeasured to reflect those changes, including an updated discount rate, if applicable, as described in the next paragraph.

11. At subsequent financial reporting dates, the lessor would consider reassessment of the discount rate used to measure the lease receivable if any of the following have occurred:

a. There is a change in the lease term.
b. The result of a change in the index or rate used to determine variable lease payments is expected to be significant.
c. There is a change in the rate the lessor charges the lessee.

These changes would alter the character of the lease such that the discount rate implicit in the lease could be significantly different. Therefore, it is appropriate that the lease receivable be remeasured using the revised rate the lessor charges the lessee.

Reporting the Deferred Inflow of Resources

12. A lessor would measure the deferred inflow of resources at the initial value of the lease receivable (see paragraph 4 of this chapter), plus the amount of any payments received at or prior to the beginning of the lease that relate to future periods (for example, the final month's rent). The Board believes that these amounts relate to future reporting periods and therefore meet the definition of a deferred inflow of resources, to be recognized as revenue on a systematic and rational basis over the term of the lease.

13. A remeasurement of the lease receivable, based on paragraphs 10 and 11 of this chapter, generally would result in the deferred inflow of resources being adjusted by the same amount. However, if the remeasurement of the lease receivable is due to a change in an index or rate used to determine variable lease payments that is attributable to the current period, the change in the amount of the lease receivable would be reported in the resource flows statements for the current period rather than as an adjustment to the deferred inflow of resources. The Board believes that this treatment appropriately reports current period flows.

Reporting the Underlying Asset

14. **The Board's preliminary view is that a lessor should not derecognize the underlying asset in the lease.** This would be a change from existing guidance for sales-type and direct financing leases, which require derecognition. The Board initially considered an approach that would derecognize the underlying asset and recognize a residual asset for the portion of the service capacity that the lessor will retain after the end of the lease. That approach would show the lessor giving up the right to use the underlying

asset in exchange for lease payments. However, that approach could be complex to apply because it involves measurements that may be highly subjective. This would be especially evident if that approach was applied to leases of real estate with different portions of one asset leased to different parties at different times. Because many of the larger leases (by amount) that governments enter into involve real estate, the Board believes that not derecognizing the underlying asset is a better alternative from a cost-benefit perspective.

15. A lessor would continue to apply other applicable guidance to the underlying asset, including depreciation and impairment, except in certain circumstances. The Board believes this approach recognizes the use of the service capacity of that asset. However, if the lease agreement requires the lessee to return the asset in its original or enhanced condition, a lessor would not depreciate the asset during the lease term. In that situation, the service capacity of that asset would be at least the same at the end of the lease as it was at the beginning, and therefore it would not be appropriate to recognize a reduction through depreciation. Additionally, if the underlying asset meets the definition of an investment, a lessor would measure the asset in accordance with guidance for investments.[4]

Disclosures for Lessors

16. **The Board's preliminary view is that a lessor should disclose the following about its lease activities**:

a. **A general description of its leasing arrangements, including the basis, terms, and conditions on which any variable lease payments not included in the lease receivable are determined**
b. **The cost (and carrying amount, if different) of assets on lease or held for leasing, by major classes of assets, and the amount of accumulated depreciation**
c. **The total amount of revenue (including lease revenue and interest revenue) recognized in the reporting period from leases**
d. **The amount of revenue recognized in the reporting period for variable lease payments and other payments not previously included in the lease receivable, including revenue related to residual value guarantees and termination penalties**
e. **A schedule of the future lease payments that are included in the lease receivable for each of the subsequent five years and in five-year increments thereafter, with reconciliation to the lease receivable for the discount (that represents interest)**
f. **If the government has issued debt for which the principal and interest payments are secured by the lease payments, the existence, terms, and conditions of options by the lessee to terminate the lease.**

17. The Board believes that the disclosures in paragraph 16 would provide essential information to financial statement users regarding a government's leasing activities as a

[4]Under the Exposure Draft, *Fair Value Measurement and Application,* the asset would be measured at fair value if it was considered an investment.

lessor. The Board also believes that the perceived benefits of these disclosures outweigh their expected costs. Several of these disclosures are, in fact, already required by current guidance.

18. The Board considered a variety of potential disclosures and decided not to propose certain additional disclosures, for example, the amount of interest revenue recognized that relates to leases and a reconciliation of the beginning and ending balance of lease receivables. The Board believes that these additional disclosures would not be essential information for users of governmental financial statements.

CHAPTER 6—SHORT-TERM LEASE EXCEPTION

1. This chapter describes an exception for short-term leases to the overall recognition, measurement, and potential disclosure requirements for lessees and lessors. It provides a definition of a short-term lease and describes the accounting treatment for such leases.

2. The Board believes that its preliminary views regarding financial reporting for lessees and lessors may be overly burdensome for leases that do not have a long-term impact on the financial statements. Therefore, the Board believes that providing an exception for these short-term leases could provide cost relief without sacrificing significant information about a government's leasing activities.

Definition of a Short-Term Lease

3. **The Board's preliminary view is that a short-term lease should be defined as a lease that, at the beginning of the lease, has a maximum possible term under the contract of 12 months or less, including any options to extend.** For a lease that is cancellable by either the lessee or the lessor, such as a month-to-month lease, the maximum possible term would be the noncancellable period, including any notice periods. A lease that is cancellable only by the lessee would be evaluated under the proposed requirements of the lease term as defined in Chapter 3.

4. In the Board's view, the shorter the timeframe that is covered by a lease, the less significant the financing component of the arrangement becomes and, therefore, the interest revenue or expense/expenditure becomes less significant. As a result, the Board's preliminary views on the accounting for short-term leases (see paragraphs 7 and 10 below) do not include the recognition of interest revenue or expense/expenditure.

5. A lease should be evaluated for its maximum possible term, including any options to extend, regardless of the probability of extension. By using the maximum possible term, it would be clear whether a lease qualifies as a short-term lease. The Board chose not to base the definition of a short-term lease on the lease term (as defined in paragraph 2 of Chapter 3) because the lease term includes consideration of the probability of exercising renewal options. For example, if it was not considered probable at inception that a renewal option would be exercised, but it actually is exercised and extends the lease term beyond one year, the lease would no longer qualify for the short-term exception. The Board believes that the monitoring effort and the resultant reclassification would negate the cost relief offered by the short-term exception.

Accounting for Short-Term Leases

6. Any lease that meets the definition of a short-term lease would be required to follow the accounting guidance described in paragraphs 7–12 below. The Board believes that establishing the exception as a requirement rather than an accounting policy election would enhance comparability between governments. The Board believes that comparability would be reduced if governments were allowed to choose whether to apply the treatment described below to some or all short-term leases.

Lessees

7. **The Board's preliminary view is that a lessee should recognize short-term lease payments as expenses or expenditures based primarily on the payment provisions of the contract.** A lessee would not recognize a lease asset or liability for a short-term lease. Accordingly, a lessee would not recognize amortization expense related to a lease asset. Likewise, a lessee also would not recognize interest expense or expenditure on a lease liability.

8. The Board believes that this treatment of a short-term lease, which is similar to current operating lease accounting, would be less burdensome to preparers than recognition of an asset and liability and subsequent recognition of amortization expense and interest expense or expenditure. Because a lease asset and liability for a short-term lease would be amortized over a brief period, this recognition may not be significant. The Board does not intend the recognition based on the payment provisions of the contract to imply a cash-basis approach. Prepaid rent or a payable for rent due still would be recognized as an asset or liability, respectively, and an expense or expenditure would be recognized in the appropriate period based on the specifics of the contract. However, if the lease allows for a rent holiday (for example, one month free), a lessee would not be required to allocate expense or expenditure to the rent holiday period.

9. A lessee would be required to disclose the amount of expense or expenditure recognized during the reporting period related to short-term leases to provide information to users about the magnitude of a government's short-term lease activity. Because this disclosure would be similar to one currently required for operating leases, the Board believes that there would be little incremental cost to provide this information.

Lessors

10. **The Board's preliminary view is that a lessor should recognize short-term lease payments as revenue based primarily on the payment provisions of the contract.** A lessor would not recognize a lease receivable or deferred inflow of resources for a short-term lease. Accordingly, a lessor would not recognize interest revenue on a lease receivable.

11. Consistent with the exception for lessees, this treatment of a short-term lease would be established for reasons of practicality. For a lease that will not last beyond 12 months, lessors would not calculate a receivable amount and impute an interest revenue component of each payment. However, a receivable would be recognized for lease payments that are due rather than for the entire contract amount.

12. A lessor would not be required to make any disclosures related to short-term leases. The Board considered certain disclosures, such as the amount of lease revenue or future payments to be received. However, the GASB research conducted indicates that this information related to lessors is not as important to financial statement users as the corresponding information related to lessees.

CHAPTER 7—LEASE TERMINATIONS AND MODIFICATIONS

1. This chapter describes the Board's preliminary views regarding lease terminations and modifications. As described in this chapter, the Board believes that the accounting should be different when a lease is terminated or modified and, therefore, it is important to distinguish between them.

Distinguishing between Lease Terminations and Modifications

2. **The Board's preliminary view is that an amendment to a lease contract should be considered a modification unless the lessee's right to use the underlying asset decreases.** Both parties to a lease contract may agree on revised terms and conditions after the original contract takes effect. These amendments could be a change in consideration, a lengthening or shortening of the lease term, an adding or removing of an underlying asset, or other alterations. The Board believes that an amendment that diminishes (but does not fully end) the lessee's right to use the underlying asset should be accounted for as a partial lease termination. In contrast, an amendment that retains the lessee's right to use the underlying asset should be accounted for as a lease modification.

3. A change in consideration or a lengthening of the lease term would be considered a modification. Shortening the lease term would be considered a partial termination. Some lease amendments add or remove underlying assets from the contract. A lease amendment that adds an underlying asset to the contract (for example, increasing the lease from three vehicles to four) would be considered a modification. The lessee's original right of use is still intact, and a new right has been added. The revised contract would be subject to the multiple component guidance discussed in Chapter 2. In contrast, a lease amendment that removes an underlying asset from the contract (for example, decreasing the lease from four vehicles to three) would be considered a partial termination. This would be consistent with the accounting that would occur if each asset were in a separate lease.

Lease Terminations

4. **The Board's preliminary view is that a lessee generally should account for the full or partial termination of a lease by adjusting the carrying values of the lease asset and related liability and recognizing a gain or loss for the difference.** When a lease is terminated, the lessee no longer has the right, or the same right, to use the underlying asset. Therefore, it would be appropriate to remove the remaining carrying value of the intangible lease asset that represents that right to use. An early termination often relieves the lessee of its obligations to make future lease payments, although there may be some final payments or termination penalties required. Therefore, it would be appropriate to adjust the carrying value of the lease liability such that the balance reflects only the payments still required. Any difference between the adjustment to the lease asset and the lease liability would be recognized as a gain or loss because it is a change in accounting estimate, with the estimate being the length of the lease term.

5. An exception to the general principle in paragraph 4 would be if the lease is terminated because the lessee purchased the underlying asset. If this occurs, the lessee

would continue to have the right to use the underlying asset because that right is embedded in its ownership. Therefore, the lease asset would be reclassified to the appropriate class of owned asset, rather than derecognized. However, the lease liability would still need to be adjusted to reflect only those payments yet to be made. The difference between any payments made for purchase and the adjusted lease liability would be recognized as an adjustment to the cost of the purchased asset instead of as a gain or loss.

6. **The Board's preliminary view is that a lessor should account for the full or partial termination of a lease by adjusting the carrying values of the lease receivable and related deferred inflow of resources, and recognizing a gain or loss for the difference.** An early termination of a lease or parts of a lease often involves a change in the timing or amount of future lease payments, and the lease receivable would be adjusted accordingly. Likewise, the deferred inflow of resources would be adjusted so that the appropriate amount of lease revenue would be recognized in the current period. Any remaining difference between the adjustment to the lease receivable and the deferred inflow of resources would be recognized as a gain or loss.

Lease Modifications

7. **The Board's preliminary view is that a lessee should account for a lease modification by remeasuring the lease liability and adjusting the lease asset by the difference between the modified liability and the liability immediately before the modification.** A lease modification is in essence a change in accounting estimate. Accounting estimates should be revised as circumstances change. The lease liability would be adjusted if there is a change in the payments to be required over the lease term. A lessee also would consider whether the discount rate needs to be updated because of the modification. Consistent with the Board's preliminary views on lessee accounting in Chapter 4, the lease asset would be adjusted by the same amount as the lease liability unless doing so would reduce the carrying value of the asset below zero.

8. **The Board's preliminary view is that a lessor should account for a lease modification by remeasuring the lease receivable and adjusting the deferred inflow of resources by the difference between the modified receivable and the receivable immediately before the modification.** A lease modification would be a change in accounting estimate for the lessor. The lease receivable would be adjusted if there is a change in payments to be received. A lessor also would consider whether the discount rate needs to be updated because of the modification. The deferred inflow of resources would be adjusted by the same amount, consistent with the Board's preliminary views on lessor accounting in Chapter 5. However, if the adjustment relates to payments for the current period, the adjustment should be recognized in the resource flows statement for the current period.

Changes in Provisions Due to Refunding of Debt

9. Existing guidance in Statement 62 provides for a different treatment if the modification of a lease is the result of a refunding of related tax-exempt debt. In this

instance, lessees would recognize a deferred inflow of resources or a deferred outflow of resources, rather than adjust the carrying value of the lease asset by the amount of the change in the lease liability. Lessors would defer the difference and recognize the amount over the shorter of the remaining life of the old debt or the new debt, rather than adjust the carrying value of the deferred inflow of resources associated with the lease. The Board believes that this guidance remains appropriate for the specific circumstances to which it applies. **However, the Board's preliminary view is that application of these provisions should not depend on whether the refunded debt is tax-exempt.** The Board does not believe that there is a substantive difference between taxable debt and tax-exempt debt such that a refunding of one would lead to a different treatment for a related lease than a refunding of the other. Therefore, these provisions would be extended to apply to refundings of taxable debt as well as tax-exempt debt.

CHAPTER 8—SUBLEASES AND LEASEBACK TRANSACTIONS

1. This chapter presents the Board's preliminary views on subleases and sale-leaseback transactions. Both are common forms of leasing transactions that are addressed in existing literature. In addition, this chapter addresses lease-leaseback transactions, which have similar characteristics to both subleases and sale-leasebacks but for which no guidance currently exists.

Subleases

2. **The Board's preliminary view is that subleases should be accounted for as transactions separate from the original leases.** A sublease takes place when a lessee in one lease (the original lease) transfers to another party (other than the original lessor) the right to use an underlying asset (in the new lease) that the lessee received as part of the original lease. The original lessee then becomes a lessor in the new lease transaction. Because there are two separate transactions (the original lease and the new lease) that are with different parties, even though they may be entered into at the same time, the Board believes that it is appropriate for each party involved to account for each transaction in accordance with the guidance for lessees and lessors. Therefore, the lessee in the original lease would recognize a lease asset and liability as lessee in the original lease and a receivable and deferred inflow of resources as lessor in the new lease (sublease). Because there are two separate transactions involving different parties, netting of the elements of each transaction would not be appropriate.

3. Information about subleases would be included in the general description of lease arrangements that is a proposed disclosure for both lessees and lessors (see Chapters 4 and 5). This information would be essential to users for understanding the nature of the government's overall leasing activities. The lessor transactions related to subleases would be disclosed separately from the original lessee transactions. This is consistent with the preliminary view discussed in paragraph 2 that sublease transactions should be accounted for separately from the original leases.

Sale-Leaseback Transactions

4. **The Board's preliminary view is that a sale-leaseback transaction should include a qualifying sale in order to be eligible for sale-leaseback accounting.** Existing guidance for sale-leaseback transactions of real estate requires the sale portion of the transaction to qualify as a sale under the provisions for sales of real estate found in Statement 62. The Board continues to believe that a sale should occur in order to account for a transaction as a sale-leaseback and that the same criteria should be used to determine if a sale has occurred regardless of whether a leaseback is involved. A sale-leaseback transaction that does not have a qualifying sale would be accounted for as a financing by both the seller-lessee and the buyer-lessor.

5. **The Board's preliminary view is that the sale and leaseback portions of a sale-leaseback transaction should be accounted for separately as a sale transaction and a lease transaction, except that any gain or loss on the sale should be deferred over the**

term of the lease. The deferral of a gain or loss on the sale recognizes the distinction between a sale with a leaseback and a sale without a leaseback. The Board believes that the leaseback is inherently related to the sale. Existing guidance in paragraph 242 of Statement 62 provides for treatment of a gain on sale as a deferred inflow of resources or deferred outflow of resources, unless the seller-lessee retains only a minor portion or less than substantially all of the remaining use of the asset. These provisions would be eliminated to simplify the process. However, for practical reasons, if the leaseback qualifies as a short-term lease, any gain or loss on the sale would be recognized immediately rather than deferred.

6. A sale-leaseback transaction would be considered to have off-market terms if there is a significant difference between either (a) the sale price and the fair value of the asset or (b) the present value of the contractual lease payments and the present value of lease payments at a market rate, whichever is more readily determinable. If a transaction has a sales price or lease payments that are higher than market, the amount of the difference would be treated as a loan that is additional to the lease. A higher-than-market sales price with higher-than-market lease payments would indicate that the seller-lessee is receiving cash both for the asset and as a loan, with the subsequent payments representing both consideration for the right to use the asset and repayment of the loan. In this circumstance, the seller-lessee would recognize the sale and lease at market rates and the difference as a loan payable. A higher-than-market sales price with at-market lease payments would indicate that the seller-lessee is receiving a grant or has entered into some other type of nonexchange transaction. If a transaction has terms that are lower than market, the amount of the difference would be included in the measurement of the lease asset by the lessee and included in the measurement of the deferred inflow of resources by the lessor.

7. A seller-lessee would be required to disclose the terms and conditions of sale-leaseback transactions. The existing disclosure requirement for sublease payments to be received when a sale does not qualify for sale-leaseback accounting would be removed. Instead, a seller-lessee in a sale that does not qualify for sale-leaseback accounting would follow disclosures applicable to long-term liabilities. A buyer-lessor would not be required to disclose any information other than what would be required for any lessor.

8. For regulated enterprises, the Board believes that the existing guidance in paragraphs 252–254 of Statement 62 that addresses sale-leaseback transactions should continue. This guidance allows for different timing of revenue and expense recognition as necessary to conform to guidance for regulated enterprises.

Lease-Leaseback Transactions

9. **The Board's preliminary view is that a lease-leaseback transaction should be accounted for as a net transaction, with disclosure of the gross amounts for each portion of the transaction.** In a lease-leaseback, each party is both a lessor and a lessee. Because each portion of the transaction is with the same counterparty, the Board believes it would be appropriate for each party to recognize a net lease payable and lease asset, or a net lease receivable and deferred inflow of resources. Some lease-leasebacks involve an additional asset being leased back. For example, land is leased to a developer that leases

back the land plus a building constructed on it. The net lease payable and lease asset (lessee of building) and net lease receivable and deferred inflow of resources (lessor of building) would represent the lease of the building alone as if the lease and leaseback of the land had not occurred. The Board believes that disclosure of the gross amounts of the lease and leaseback would provide users with essential information about the magnitude of each portion of the transaction.

CHAPTER 9—LEASES WITH RELATED PARTIES AND INTRA-ENTITY LEASES

1. This chapter presents the Board's preliminary views regarding leases with related parties and intra-entity leases. Existing literature provides guidance on these types of leases, and the Board believes that guidance remains appropriate.

Leases between Related Parties

2. **The Board's preliminary view is that leases between related parties should be recognized based on the substance instead of the form of the transaction.** This is consistent with the overall guidance for related parties that is found in Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards.* The Board continues to believe that it is more appropriate to reflect the economic substance of a transaction if the substance is different from the form because the transaction involves a related party. Related party disclosure requirements found in paragraphs 55 and 56 of Statement 62 would apply to lease transactions.

Intra-Entity Leases

3. **The Board's preliminary view is that the existing guidance regarding leases within financial reporting entities, found in Statement No. 14, *The Financial Reporting Entity,* as amended, should remain in effect.** Statement 14 refers to the guidance for leases in NCGA Statement 5, as amended. This requirement provides that all leases with (or between) blended component units should not be reported as leases in the financial statements of the reporting entity. NCGA Statement 5 provides that the leased asset would be reported as a capital asset of the lessee primary government, and any related debt of the lessor component unit would be reported as debt of the primary government. Lease arrangements with discretely presented component units are treated as if they were with an unrelated entity, except for requirements to present the lease receivables and payables separately from other due to and due from component unit balances and from lease receivables and payables with outside organizations. This guidance is a specific application of the general guidance for transactions with component units and, therefore, would be appropriate to retain.

4. With respect to leases with or between blended component units, for which eliminations are required, the Board believes that these eliminations should be made before the financial statements of the blended component units are aggregated with those of the primary government. While the effects of the lease (such as lease-related assets, liabilities, revenues, and expenses, depending on whether the entity is a lessee or lessor) would be reflected in any separately issued financial statements of a blended component unit, those effects would need to be eliminated before that component unit's information is brought into the financial statements of the primary government. After eliminations, the

financial statements would reflect only a cash payment between components that would represent interfund services provided and used. The Board believes that this approach reduces complexity to the financial statements without sacrificing essential information to financial statement users.