NORTH CAROLINA
DEPARTMENT OF STATE TREASURER

STATE TREASURER OF NORTH CAROLINA
DALE R. FOLWELL, CPA

STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

SHARON EDMUNDSON
DEPUTY TREASURER

Memorandum # 2021-05

TO: **Local Government Finance Officials and Their Independent Auditors**

FROM: **Sharon Edmundson, Deputy Treasurer, State and Local Government Finance Division**

SUBJECT: **GASB Statement No. 87, *Leases***

DATE: **December 1, 2020**

The Governmental Accounting Standards Board (GASB) issued Statement No. 87, *Leases*, in June 2017. This statement was originally effective for reporting periods beginning after December 15, 2019; however, the GASB postponed the implementation of GASB 87 and the related Implementation Guide 2019-3 for 18 months because of the COVID-19 pandemic. For most NC local governments and public authorities in North Carolina, this statement is now effective for the fiscal year beginning July 1, 2021. GASB intentionally provided a long lead time on implementation because there are significant planning and possible financial systems changes needed to successfully implement the standard. This memorandum will focus primarily on the policy and planning aspects associated with the lease guidance. We plan to issue a subsequent document over the next few months that addresses the reporting requirements associated with GASB Statement No. 87.

GASB Statement No. 87 eliminates existing lease accounting and reporting guidance, including the “capital” versus “operating” lease criteria, that have been used to categorize leases for decades. With such a pervasive change, governments will need time to understand the reporting changes, develop appropriate policy and business processes to track legal agreements and related data, and consider possible system updates to track accounting and reporting changes.

Under the new guidance, a lease is defined as “a contract that conveys control of the *“right to use”* another entity’s nonfinancial asset for a period of time in an exchange or exchange-like transaction”. The underlying assumption of the statement is that a lease is really a *financing transaction*. **Lease contracts convey the “right to use” which is an underlying nonfinancial intangible asset, rather than the actual asset itself, to the lessee.** That is, the lessee is procuring an intangible asset that is a “right to use” asset, not the physical asset itself. For the lessor, the right to receive payments in exchange for a lessee’s “right to use” is a resource that can be drawn upon going forward. Nonfinancial assets are items such as land, buildings, vehicles, and equipment. A contract that meets the definition of a lease should be accounted for using the lease accounting standard, even though the parties involved or the agreement itself may not refer to the arrangement as a lease.

Exceptions to Lease Accounting

The lease reporting exceptions allowed in the statement are minimal. Short term leases with a maximum possible term of 12 months (including any options to extend) may be accounted for by the lessee as expenditures/expenses or revenues by the lessor based on the provisions of the contract. In addition, a contract that transfers ownership at the end of the contract is a financed purchase, not a lease. Lease accounting would not apply to either of these situations.

Some types of leases specifically excluded from the scope of Statement No. 87 are: service contracts (unless it includes both a lease and a service component), leases for intangible and biological assets, inventory, service concession arrangements (see GASB Statement 60 for these), certain conduit debt financed assets, and supply contracts such as power purchases.

Subscription-based information technology arrangements are addressed in GASB Statement No. 96 that is effective for periods beginning after June 15, 2022. The guidance in GASB Statement No. 96 is based on GASB Statement No. 87, with the added complexity that some internally developed software modifications may be required to be capitalized. We plan to issue separate guidance related to GASB Statement No. 96 in the future.

Lessee Accounting under GASB Statement 87
Except for the few exceptions that are noted in the standard, governmental lessees will report a liability for the present value of lease payments due to the lessor over the lease term. The liability is offset with an intangible asset representing the "right to use" an underlying asset in their full accrual financial statements – meaning their government-wide statements and any proprietary funds that report a leased asset. Governments will amortize the intangible asset over the shorter of the asset's useful life or the lease term and the liability will be reduced by lease payments offset by interest expense.

In the governmental funds, lessees will report an expenditure and an offsetting other financing source in the period the lease is initially recognized at an amount equal to the present value of the lease liability. Subsequent lease payments should be budgeted and accounted for as debt service principal and interest expenditures using the modified accrual basis of accounting. For governmental funds, this is a continuation of the current accounting standards for capital leases. The change is that the guidance will now apply to all leases.

Lessor Accounting under GASB Statement 87
Governmental lessors, in their full accrual financial statements, will report a lease receivable and a deferred inflow of resources on the government wide statements; however, the underlying asset will <u>**NOT**</u> be removed from the lessor's records. Over the life of the lease, the lessor will depreciate the leased asset and reduce the receivable by lease payments, adjusted to cover interest revenue. The deferred inflows will be reduced and recognized as revenue in a systematic and rational manner over the lease term.

In the governmental funds, lessors will recognize a lease receivable and a deferred inflow of resources. The deferred inflow of resources should be measured at the initial value of the lease receivable plus payments received at or before commencement of the lease term that relate to future periods. The deferred inflows should be recognized as inflows of resources in a systematic and rational manner over the term of the lease.

Determining the Lease Term
One of the key concepts in GASB Statement No. 87 is the definition of the lease term, both for the lessor and the lessee. The length of the lease term is critical to determining the value of a lease. Lease terms always include the period of time that the lessee has a noncancelable right to use the underlying asset. Periods of time when the lessee <u>and/or</u> the lessor can extend the lease without requiring consent of the other party, if it is reasonably certain that the option will be exercised, should also be included in the calculated lease term. Additionally, periods of time that the lessee <u>or</u> the lessor have an option to terminate should be included in the lease term, if it is reasonably certain that the option to terminate will not be exercised by the party. Month-to-month leases after the end of the noncancelable term in which either party can end the lease would not be included in the lease term.

Fiscal funding clauses that are often included in public sector contracts do not affect the lease term unless if it is reasonably certain they will be enacted.

Materiality

GASB Statement No. 87 requires leases, with a few exceptions, be reported in the financial statements. **The statement provisions may not apply to assets or liabilities that are determined to be immaterial; however, local governments and public authorities will need to review their agreements and document their findings for their auditors before they can determine materiality.** When considering whether lease transactions are material, you and your auditor should consider the materiality of leases in the aggregate and individually. For example, the lease of five (5) law enforcement vehicles may not be material to a large city or a county, but a small town within the county might materially misstate assets and liabilities if the lease of five vehicles is not included in their financial statements. Correspondingly, the individual lease of five law enforcement vehicles may not be material to the city or county, but a program to lease all law enforcement vehicles may be material and these five leases that represent a portion of the program should be included in aggregate. Typically, materiality for leased assets and lease obligations must be separately evaluated.

Legislative and Contractual Changes

The LGC and local governments will need to consider how GASB 87 impacts both legislative and contractual language. The LGC staff reviewed the NC Local Government and Fiscal Control Act (NCGS 159) as well as other related accounting and reporting statutes to determine what changes we may need to consider related to GASB 87 implementation. We identified several statutes in Chapter 115C – Elementary and Secondary Education, specifically 115C-530(a)(4) and 115C-528 and 115C-441 (c1), that we may need to pursue technical corrections for in the next General Assembly session. There may be other statutory changes or clarifications needed as we continue this work.

Local governments utilize the now-obsolete terms, operating and capital leases, in legal bond or bank documents, particularly revenue bond documents that define rate or debt coverage ratios that refer to capital lease language in their definitions. Depending upon the language utilized in a given debt document and how the change in reporting will impact the calculations, a government may need to compare the old lease definition with the new definition of leases to make sure that the change in GASB guidance is not materially impacting the coverage ratio calculation. Depending upon the results of this work, units may need to consider revising debt documents. Units that have debt with covenants will need to work with their bond counsel to determine whether any changes need to be made in bond document definitions and when those changes should be made. We reviewed some typical debt language included in recent revenue bond documents as we were preparing this communication. We don't expect a significant issue here, but each unit will have to review their own debt documents to make sure they are continuing to provide what they have committed to provide to their bondholders.

Service Agreements

For a variety of business reasons, local governments may choose to execute various service agreement contracts to obtaining and maintain new equipment, such LED lighting or solar panels. These contracts, which meet the definition of a lease under GASB Statement 87, typically involve a vendor (lessor) installing their equipment in the government's (lessee) facilities and maintaining it for the government. Ownership of the equipment is not transferred to the government although some agreements may include a right for the government to purchase at fair market value in the future. In return for use of more energy efficient equipment, the government incurs an energy savings fee that is computed in accordance with the agreement and shares the energy savings with the vendor.

The payments associated with these service agreements may be a mixture of fixed and variable payments or completely variable. The energy savings fee is calculated based on utility costs and usage for a given period of time, both of which are variable. Governments will need to analyze any service agreements to determine if the agreements are completely variable or a mixture of variable and fixed costs. Agreements that are completely variable would result in no amounts being due to the vendor in a period with no energy savings. Per paragraph 22 of GASB 87, variable lease payments made to the vendor are recognized as expenditures or expenses in the period during which the obligations are incurred. Only those components of lease payments that are fixed in substance are included in the lease liability; therefore, a service agreement that is completely variable not have any impact to the statement of net position. The unit will need to disclose the service agreement as a lease in accordance with the standard.

Next Steps
To successfully implement such a pervasive change in accounting and reporting leases, local governments and public authorities will also need to address several key issues, including, but not limited to:

- ***Do we have a complete listing of all our legal agreements and information applicable under the new guidance?***

Local governments should have a schedule of existing leases as of the end of the prior fiscal year to support the current lease reporting requirements. This list is a good starting point to begin their work to implement the new guidance, but it will **NOT** include all the information they will need to report and disclose. **Agreements that are currently not called leases under the existing reporting practices may meet the definition of a lease under GASB Statement No. 87. Agreements that are currently reported as leases may not meet the definition of a lease under the new guidance. All existing arrangements involving non-financial assets (except for those assets explicitly excluded) will need to be evaluated**. Under the new standard, a lease is defined as a "contract that conveys control of the right to use another entity's nonfinancial asset for a period of time in an exchange or exchange-like transaction." ***Existing legal contracts and agreements involving nonfinancial assets that are not reported as leases under existing lease reporting guidance will need to be evaluated to determine if they meet the definition of a lease under the revised guidance.***
You will need to communicate with your departments to develop a master file of the organization's legal agreements and the terms based upon the new reporting requirements. Decentralized units of government may struggle to compile complete listings and obtain copies of all executed legal agreements to assess. Finance staff will need to work collaboratively with department leadership to educate them on the new lease definitions and develop a complete listing of the entire population of agreements.

In October 2020, the Government Finance Officer's Association (GFOA) published some very helpful sample Lease Accounting spreadsheets and scenarios in their materials library here. However, governments must be a member of GFOA to have access to this assistance. For those who are GFOA members, we urge you to utilize these resources. Those governments that are not GFOA members may be able to access similar resources from their independent auditors, depending upon what firm they use. We are still considering what we will provide local governments preparing to implement GASB 87; that guidance will be issued in the spring of 2021.

- ***What additional staff time or resources might we need to evaluate our legal agreements and capture new lease reporting and disclosure information?***

The evaluation of existing, amended, and new legal contracts for lease reporting and disclosure requirements is time consuming and complex. Existing leases will need to be evaluated to capture data and calculations required for the revised reporting and note disclosures. Once an agreement has been determined to be a lease under the GASB 87 guidance, it will need to be analyzed to determine the lease term per the GASB standard, possible variable payments, the discount rate, residual value guarantees, lease incentives, non-lease components such as maintenance, taxes, utilities or common area maintenance, or volume surcharges. This data will be used to calculate the lease term, liability, asset, and the monthly lease payments.

The data for each agreement will need to be tracked in a manner that can be maintained and is available for reporting purposes when needed. **Units will need to contact vendors to clarify the language in the agreements and obtain information needed for reporting that is not currently included in the agreements. You may need to advise vendors how to rework your monthly billing formats or revise the language in your lease agreements to obtain the information you need for reporting and note disclosures.** A significant portion of the legwork to implement the lease standard will be educating the vendor community so that they routinely include required information in your agreements and in related billing.

Some agreements may consist of multiple components, some of which are leases and some that are not. For example, an equipment lease could include a component for the equipment lease as well as a nonlease component for maintenance and routine repairs. Governments will need to account for these as separate contracts to the extent practicable. Vendors will need to provide pricing for the individual components so that the lease and nonlease costs can be allocated. The amounts used in allocations should be reasonable, based on professional judgement and observable information, such as stand-alone prices. If it is not practicable to allocate among lease and nonlease components, then governments can account for these as a single lease. The expectation is that, over time, vendors will begin to provide this type of information as the changes are implemented with GASB 87.

Whatever staff person(s) complete the document review and evaluation work for the local government will need training on the standard so they understand the accounting and reporting requirements and can apply them appropriately. Staff assigned this work must have adequate time available in their work week to research and implement the standard.

- ***What other legal agreements exist that meet the definition of a lease under the new guidance?***

Some of the legal agreements that local governments and public authorities will need to analyze may be quite complex and require significant time to understand before determining the proper accounting treatment. Depending upon the complexity of the agreement, Finance staff may need to consult with the vendor, bond counsel or the unit's attorney to help them understand legal requirements.

Often governments execute contracts as a lessee or a lessor that involve the "right to use" as asset for a nominal amount, such as $1. In substance, these transactions are nonexchange transactions, such as a donation or a grant, that will not be defined as a lease under GASB Statement No. 87. Leases are defined in Statement 87 as exchange or exchange-like transactions and these $1 nominal arrangements are not exchange transactions. These agreements or groups of similar agreements will need to be evaluated against the new standard to determine proper reporting under the requirements and the work should be documented as needed to satisfy the unit's external auditor.

- ***What policies and procedures do we have in place for initiating, modifying or terminating legal agreements that may need to be revised?***

Units will need to review and revise their internal policies, such as debt, capital asset accounting and reporting, procurement, and contracting. Any internal policy based upon the now obsolete criteria of "operating" versus "capital" leases will need to be revisited. If applicable, these policy changes will need to be approved by the governing Board. Governments that maintain their own contract template terms for vendors may need to collaborate with their unit attorney to rewrite contract language. Legal agreements will need to include language requiring data needed for revised lease accounting and reporting. Vendors may need education about specific information needed under the new guidance that you don't ask them for now. Debt covenants for bond documents will need to be reviewed and may need to be revised over time. External entities, such as credit rating agencies or lenders may have questions that will need to be addressed.

A government may consider adopting a higher capitalization threshold as part of implementing GASB 87. A higher limit would help mitigate the costs associated with reporting and tracking smaller leases and capture the larger leases that meet the definition of materiality for the government. A common threshold for capital assets is $5,000, but governments could consider a higher threshold. However, Question 4.23 in the Implementation Guide 2019-3, *Leases*, requires lessees to consider the significance of both the lease asset and the lease liability when applying the capitalization limit to leases. Lease liabilities that are significant, either individually or in the aggregate, should still be recognized. As was previously stated, lease assets and lease liabilities may have different materiality thresholds. Units should carefully consider and evaluate any contract that qualifies as a lease before dismissing it as being immaterial to the financial position of the unit.

- ***How will our lease agreement records be updated and maintained during the fiscal year and beyond to track changes required by the guidance? What business processes (and eventual software upgrades) do we need to implement so we can report the accounting and note disclosures required?***

Each time your government executes, modifies, or terminates a legal agreement or contract that meets the definition of a lease, the information associated with the reporting of leases will be impacted and will need to be revised. Lease modifications can be triggered by numerous events, including routine annual price increases from lessors. For local governments or public authorities, these extensive changes will need to be analyzed and captured during the fiscal year, not as part of the year end audit and reporting process.

Depending upon the number of agreements your government must review and track, you may need to look at implementing software system revisions or updates to accommodate the lease accounting and reporting needs. Software providers do not envision and develop changes overnight. There is a long lead time before software providers understand these requirements and develop the changes in their systems. Do not wait to contact them; reach out to your software provider now to see what work they are it is already doing to implement this guidance and understand their timeline. They may not yet have the lease reporting changes on their radar. You may need to drive some of their deadlines to make sure you have the functionality you need to implement these changes timely. Depending upon the availability of the revised lease functionality, you may have to develop a business process work-around to accomplish your needs.

In conclusion, we plan to provide additional guidance on reporting under the new lease standard over the next few months but urge you to educate yourself on this standard now. **It is important to plan for the research work needed and consider how the changes might impact your business processes.** If you have further questions in this memorandum, please contact a staff member of the State and Local Government Finance Division staff at 919-814-4300.