

OHIO AUDITOR OF STATE KEITH FABER



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TO: All Public Offices
Independent Public Accountants

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SUBJECT: GASB 87, *Leases*

Background Information

The Governmental Accounting Standards Board (GASB) issued GASB Statement No. 87, *Leases*, in June 2017. This statement establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under GASB 87, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources. (GASB 87 Summary) GASB 87 and subsequent amendments and guidance are codified in GASB Codification L20.

The requirements of this statement apply to all Ohio state and local governments that prepare financial statements following generally accepted accounting principles (GAAP). Applicability to Non-GAAP entities is addressed later in this bulletin.

Effective Date

As a result of GASB Statement No. 95, which amended the effective dates of certain GASB pronouncements due to the COVID-19 pandemic, the requirements of GASB 87 are effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Therefore governments in Ohio are required to implement GASB 87 beginning with fiscal years ended June 30, 2022 and ending December 31, 2022.

Additional Guidance

GASB has also issued the following implementation guidance which clarify the provisions of GASB 87. These questions are being incorporated into the Comprehensive Implementation Guide, Chapter 12 as they become effective. However, we have referenced original Implementation Guides to reflect the effective date of the questions.

Guide:	Specific Questions, where applicable:	Effective for fiscal years beginning after:
Implementation Guide No. 2019-3, Leases		June 15, 2021
Implementation Guide No. 2020-1, <i>Implementation Guide Update – 2020</i>	Questions 4.6-4.17	December 15, 2021
Implementation Guide No. 2021-1, <i>Implementation Guide Update - 2021</i>	Question 4.22	June 15, 2021
	Questions 4.4-4.21	June 15, 2022

In addition, in April 2022, GASB issued Statement No. 99, *Omnibus 2022*, which includes additional provisions related to leases. The provisions in this statement applicable to leases are effective for fiscal years beginning after June 15, 2022, unless implemented earlier. Due to the ability to early implement these GASB 99 lease provisions, AOS felt it was necessary to include them in this Bulletin. If your entity does not early implement, the GASB 99 guidance included in this Bulletin would not be applicable until fiscal years beginning after June 15, 2022.

The guidance contained within this Bulletin contains only a portion of the above guidance and the basic requirements of GASB 87. Readers of this Bulletin are strongly encouraged to review GASB 87 and the aforementioned implementation guidance in full given the complexity of the statement.

GASB 87 Definition of a Lease

Under GASB 87, a lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. (GASB 87 ¶ 4) The components of this definition are particularly important in determining whether a contract is considered a lease under these provisions. A contract must meet this definition in its entirety in order to qualify for reporting as a lease.

Contract

Leases include contracts that, although not explicitly identified as leases, meet the definition of a lease. The definition excludes contracts for services except those contracts that contain both a lease component and a service component. (GASB 87 ¶ 6)

Conveys Control of the Right to Use

To determine whether a contract conveys control of the right to use the underlying asset, a government should assess whether it has both of the following:

- The right to obtain the present service capacity from use of the underlying asset as specified in the contract
- The right to determine the nature and manner of use of the underlying asset as specified in the contract

(GASB 87 ¶ 5)

Another Entity's

Leases between funds/departments of the reporting entity do not meet the GASB 87 definition of a lease. (See GASB Imp. Guide 2021-1 4.4)

Nonfinancial Asset

GASB 87 footnote 2 (which references GASB 72 ¶ 86) defines a financial asset as “cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity the right to do either of the following:

- a. Receive cash or another financial instrument from a second entity.
- b. Exchange other financial instruments on potentially favorable terms with the second entity (for example, an option). “

Examples of nonfinancial assets include land, buildings, vehicles and equipment. (GASB 87 ¶ 7)

Exchange or Exchange-Like Transactions

In order to meet the definition of a lease under GASB 87, the substance of the transaction must be an exchange or exchange-like transaction. An exchange and exchange like transaction represents a transaction in which each party gives up essentially equal value. (GASB 33 ¶ 1) Some governmental contracts that transfer the right to use an asset require only a nominal amount, such as one dollar per year, to be exchanged for the right to use the underlying asset. GASB believes that the substance of that type of arrangement represents a nonexchange transaction (such as a donation or grant), which is addressed within the scope of GASB Statement No. 33, because each party does not receive or give up essentially equal value or not quite equal value. (GASB Imp. Guide 2019-3 4.1)

Exclusions

The requirements of GASB 87 do not apply to the following:

- Leases of intangible assets (except those intangible right to use assets that are created by the original leases of tangible underlying assets)
- Leases of biological assets, including timber, living plants, and living animals
- Leases of inventory
- Contracts that meet the definition of a service concession arrangement in paragraph 4 of Statement No. 60

- Leases in which the underlying asset is financed with outstanding conduit debt, unless both the underlying asset and the conduit debt are reported by the lessor (see GASB 91)¹
- Supply contracts, such as power purchase agreements
- Certain public-private and public-public partnerships (PPP) (see GASB 94)¹
- Subscription-based information technology arrangements (see GASB 96)¹

(GASB 87 ¶ 8 as amended by GASB 91, GASB 94 and GASB 96)

Lease Term

The lease term is the period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period), plus the following periods, if applicable, based on all relevant factors and reasonable certainty:

Period covered by option of:	Option to:	Reasonably certain:
Lessee	Extend the lease	Lessee will exercise the option
Lessee	Terminate the lease	Lessee will NOT exercise the option
Lessor	Extend the lease	Lessor will exercise the option
Lessor	Terminate the lease	Lessor will NOT exercise the option

Periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party (or if both parties have to agree to extend) are cancelable periods and are excluded from the lease term. For example, a rolling month-to-month lease, or a lease that continues into a holdover period until a new lease contract is signed, would not be enforceable if both the lessee and the lessor have an option to terminate and, therefore, either could cancel the lease at any time. (GASB 87 ¶ 12) GASB 99 ¶ 11a further explains that an option to terminate is an unconditional right that exists within a lease contract and clarifies that a provision that allows the lessor or lessee to terminate the lease only in certain circumstances (for example, a default on payments) should not be considered an option to terminate for the purposes of determining the lease term.

When a lessee has the option to purchase the underlying asset during the term of the lease and the contract is not a contract that transfers ownership (contracts that transfer ownership are discussed later in this bulletin), the period, if any, after which the option is reasonably certain of being exercised should be excluded. (GASB 99 ¶ 11b)

¹ GASB 87 ¶ 8 has subsequently been amended by GASB 91 (*Conduit Debt Obligation*), GASB 94 (*Public-Private and Public-Public Partnerships and Availability Payment Arrangements*), and GASB 96 (*Subscription-Based Information Technology Arrangements*). GASB 91 is effective for reporting periods beginning after December 15, 2021. GASB 94 and 96 are effective for fiscal years beginning after June 15, 2022. Readers of this Bulletin are encouraged to review these statements in detail upon implementation as the details of these statements are not covered within this Bulletin.

Provisions that allow for termination of a lease due to the following are not considered termination options (GASB 87 ¶ 12):

- Purchase of the underlying asset
- Payment of all sums due, or
- Default on payment.

GASB 99 ¶ 11c further clarifies that this sentence should only be applied to the evaluation of contracts that transfer ownership (contracts that transfer ownership are discussed later in this bulletin).

A fiscal funding or cancellation clause allows governmental lessees to cancel a lease, typically on an annual basis, if the government does not appropriate funds for the lease payments. This type of clause should affect the lease term only if it is reasonably certain that the clause will be exercised. (GASB 87 ¶ 13)

Short-Term Leases

A short-term lease, at the commencement of the lease term, has a maximum possible term of 12 months (or less), including any options to extend, regardless of their probability of being exercised. Lessees and lessors should recognize short-term lease payments as outflows of resources (for example, expense) or inflows of resources (for example, revenue), respectively, based on the payment provisions of the lease contract. (GASB 87 ¶¶ 16-18)

GASB 99 ¶ 12 provides the following clarifications regarding short-term leases:

- Any periods in which both the lessee and lessor have an option to terminate the lease without permission of the other party should not be included in the maximum possible term.
- A lease should be reassessed from the inception of the lease if the lease was previously determined to be short-term but has been modified to extend the initial maximum possible term under the lease contract. After this reassessment, if the maximum possible least term is greater than 12 months, the lease should no longer be considered short-term.
- If a lease is reclassified from a short-term lease (see previous bullet point), the lease term should be assessed beginning at the date of modification for purposes of measuring the lease receivable or lease liability.

Contracts that Transfer Ownership

A contract that (a) transfers ownership of the underlying asset to the lessee by the end of the contract and (b) does not contain termination options, but that may contain a fiscal funding or cancellation clause that is not reasonably certain of being exercised, should be reported as a financed purchase of the underlying asset by the lessee or sale of the asset by the lessor. (GASB 87 ¶ 19)

Lease Accounting – Lessee

A lessee should recognize a lease liability and a lease asset at the commencement of the lease term, unless the lease is a short-term lease or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs. (GASB 87 Summary)

A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The notes to financial statements should include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made. Refer to GASB 87 ¶¶ 37-39 for further disclosure requirements. (GASB 87 Summary)

Lessee Accounting	
Initial Measurement	Subsequent Measurement
<p>Lessee Lease Liability The measurement of the lease liability should include the following if required by the lease:</p> <ul style="list-style-type: none"> • Fixed payments • Variable payments that depend on an index or a rate** • Variable payments that are fixed in substance** • Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees • The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option • Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to termination the lease or (2) a fiscal funding or cancellation clause • Any lease incentives receivable from the lessor (refer to GASB 87 ¶¶ 61-62) • Any other payments that are reasonably certain of being required based on an assessment of all relevant factors <p>(GASB 87 ¶ 21)</p>	<p>For subsequent financial reporting periods, the lessee should calculate the amortization of the discount on the lease liability and report that amount as an outflow of resources (for example, interest expense) for the period. Any payments made should be allocated first to the accrued interest liability and then to the lease liability. (GASB 87 ¶ 24) In other words the ending lease liability for the period will represent the beginning lease liability less the principal portion of payments made. Interest expense for the reporting period will represent the interest portion of lease payments made plus accrued interest at the end of the period less accrued interest at the beginning of the period.</p> <p>A lease asset should be amortized in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset, except, if a lease contains a purchase option that the lessee has determined is reasonably certain of being exercised, the lease asset should be amortized over the useful life of the underlying asset (if the underlying asset is nondepreciable, such as land, the lease asset should not be</p>

<p>The future lease payments should be discounted using the interest rate the lessor charges the lessee, which may be the interest rate implicit in the lease. If the interest rate cannot be readily determined by the lessee, the lessee's estimated incremental borrowing rate (an estimate of the interest rate that would be charged for borrowing the lease payment amounts during the lease term) should be used. (GASB 87 ¶ 23)</p> <p>Lessee Lease Asset A lessee should initially measure the lease asset as the sum of the following:</p> <ul style="list-style-type: none"> • The amount of the initial measurement of the lease liability (see above) • Lease payments made to the lessor at or before the commencement of the lease term, less any lease incentives (refer to GASB 87 ¶¶ 61-62) received from the lessor at or before the commencement of the lease term • Initial direct costs that are ancillary charges necessary to place the lease asset into service <p>(GASB 87 ¶ 30)</p>	<p>amortized). The amortization of the lease asset should be reported as an outflow or resources (for example, amortization expense), which may be combined with depreciation expense related to other capital assets for financial reporting purposes. (GASB 87 ¶¶ 31-32)</p> <p>If a lease asset is impaired (refer to GASB 42), the amount reported for the lease asset should be reduced first by any change in the corresponding lease liability. Any remaining asset should be recognized as an impairment (GASB 87 ¶ 34)</p> <p>Therefore, the ending lease asset should be equal to the beginning lease asset less any amortization expense that is recognized during the period less an impairment loss recognized during the period (if any).</p>
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**According to GASB 99 ¶13, all other variable payments, such as those based upon future performance of the lessee or usage of the underlying asset, should not be included in the measurement of the lease liability.

Expense Recognition

As previously noted, GASB 87 requires that a lessee recognize interest expense related to the amortization of the discount on the lease liability. A lessee also should recognize amortization expense related to the lease asset, representing the decrease in the useful life of the right to use the underlying asset over the lease term. The interest expense and amortization expense are reported in the resource flows statements with other interest and depreciation or amortization expense amounts. The interest and amortization expenses related to a lease should not be combined and reported as a single rent expense amount, so that the expense could be classified as an operating expense, consistent with the manner in which expenses for operating leases were classified in GASB 62. (GASB 87 ¶ B54)

Also, as previously mentioned, the amortization of the lease asset should be calculated in a systematic and rational manner. This is consistent with depreciation and amortization of other capital assets. Amortization in a systematic and rational manner does not necessarily mean the

same amount would be amortized in each period. For example, a calculation that results in a constant total lease cost (the total of the separately determined interest and amortization) could be considered systematic and rational in some cases. (GASB 87 ¶ B56)

Governmental Funds

An expenditure and other financing source should be recognized in the period the lease is initially recognized. Subsequent payment should be accounted for consistent with principles for debt service payments on long-term debt. (GASB 87 ¶ 36)

Lease Accounting – Lessor

A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term, with certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases, and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease. The lease receivable should be measured at the present value of lease payments expected to be received during the lease term. The deferred inflow of resources should be measured at the value of the lease receivable plus any payments received at or before the commencement of the lease term that relate to future periods. (GASB 87 Summary)

A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflows of resources in a systematic and rational manner over the term of the lease. The notes to financial statements should include a description of leasing arrangements and the total amount of inflows of resources recognized from leases. Refer to GASB 87 ¶¶ 57-60 for further disclosure requirements. (GASB 87 Summary)

Lessor Accounting	
Initial Measurement	Subsequent Measurement
<p>Lessor Lease Receivable The measurement of the lease receivable should include the following if required by the lease:</p> <ul style="list-style-type: none"> • Fixed payments • Variable payments that depend on an index or a rate** • Variable payments that are fixed in substance** • Residual value guarantee payments that are fixed in substance • Any lease incentives payable to the lessee (refer to GASB 87 ¶¶ 61-62) <p>(GASB 87 ¶ 44)</p> <p>The future lease payments to be received should be discounted using the interest rate</p>	<p>In subsequent financial reporting periods, the lessor should calculate the amortization of the discount on the lease receivable and report that amount as an inflow of resources (for example, interest revenue) for the period. Any payments received should be allocated first to the accrued interest receivable and then to the lease receivable. (GASB 87 ¶ 48)</p> <p>Regarding the deferred inflow of resources, a lessor subsequently should recognize the deferred inflow of resources as inflows of resources (for example, revenue) in a systematic and rational manner over the term of the lease. (GASB 87 ¶ 54)</p>

<p>the lessor charges the lessee, which may be the interest rate implicit in the lease. (GASB 87 ¶ 47) Even when the lease payments are established using a method that does not involve an interest rate, a discount rate can be imputed on any future payment stream, even though it was not factored into the determination of payment amounts. (GASB 87 ¶ B69)</p> <p>Lessor Deferred Inflows of Resources The initial measurement of the deferred inflow of resources should equal the amount of the initial measurement of the lease receivable from above plus lease payments received from the lessee at or before the commencement of the lease term that relate to future periods (for example, the final month's rent) less any lease incentives (see GASB 87 ¶¶ 61-62) paid to, or on behalf of, the lessee at or before the commencement of the lease term. (GASB 87 ¶ 53)</p>	
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**According to GASB 99 ¶ 15, all other variable payments, such as those based upon future performance of the lessee or usage of the underlying asset, should not be included in the measurement of the lease receivable.

Lessor Accounting - Underlying Asset

A lessor should not derecognize the asset underlying the lease. A lessor should continue to apply other applicable guidance to the underlying asset, including depreciation and impairment. However, if the lease contract requires the lessee to return the asset in its original or enhanced condition, a lessor should not depreciate the asset during the lease term. (GASB 87 ¶ 55)

Governmental Funds

In governmental funds, a lessor should:

- Recognize a lease receivable and deferred inflow
- Measure deferred inflow at the initial value of the lease receivable plus the amount of any payments received at or before the commencement of the lease term that related to future periods.
- Recognize the deferred inflow as inflows of resources (for example, revenue), if available, in a systematic and rational manner over the term of the lease.

(GASB 87 ¶ 56)

Lease Accounting – Transition

Leases should be recognized and measured using the facts and circumstances that existed at the beginning of the period of implementation. (GASB 87 ¶94) For example, a school district implementing GASB 87 for fiscal year 2022 should recognize and measure any leases which existed prior to the fiscal year using the facts and circumstances that existed as of July 1, 2021. Governments may wish to refer to GASB Implementation Guide 2019-3, questions 4.76 and 4.77 for more detailed guidance regarding the recognition and measurement of leases at transition. For those governments preparing comparative financial statements, GASB 87 ¶ 93 requires the effects of GASB 87 to be applied retroactively by restating the financial statements for all prior periods presented.

Lease Accounting – Other

GASB 87 contains additional information to the above topics that are not covered within this Bulletin, including, but not limited to:

- Contracts with Multiple Components and Contract Combinations
- Lease Modifications and Terminations
- Subleases
- Sale-Leaseback Transactions
- Lease-Leaseback Transactions
- Intra-entity Leases
- Leases between Related Parties

For specific guidance related to these topics please refer to GASB 87 or GASB Codification L20.

Applicability to Non-GAAP Entities

GASB 87 requires the recognition of certain lease assets and lease liabilities for leases that meet the GASB 87 definition. This definition may include contracts that were previously classified as operating leases.

These lease assets and liabilities will not be recognized on regulatory statements or on OCBOA cash basis (unmodified); therefore, regulatory and OCBOA cash basis (unmodified) filers will only need to incorporate changes to their Notes to the Basic Financial Statements. When preparing the Notes to the Basic Financial Statements, for both regulatory and OCBOA cash basis (unmodified), the following note disclosures should be made:

- the summary of significant accounting policies should describe the accounting treatment for leases (leases as defined by GASB 87)
- the debt note should include disclosures for financed purchases (as defined by GASB 87)

For OCBOA modified cash basis, modifications for lease assets/liabilities should only be made when the transaction follows a cash transaction, there is substantial support in GAAP or other accounting literature, and the modification is logical. Since not all OCBOA modified cash basis preparers will elect to make this modification for leases, note disclosures should be made as follows:

- If a local government is electing to make a modification for GASB 87 because the GASB 87 lease follows a cash transaction, the corresponding disclosure requirements from GASB 87 should be made.
- If an OCBOA modified cash basis preparer is electing not to make the GASB 87 modifications, the OCBOA cash basis (unmodified) disclosures identified above should be made.

Additional Resources Available on the Auditor of State’s Website

The Auditor of State’s Office has a Frequently Asked Questions (FAQ) document available related to the implementation of GASB 87 on our website at:

<https://ohioauditor.gov/references/gasbfaqs.html>

This document contains both frequently asked questions and examples related to the implementation of GASB 87 and will be updated as additional information becomes available.

Questions

If you have any questions regarding the information presented in this Bulletin, please contact Local Government Services at (800) 345-2519 or ContactLGS@ohioauditor.gov.



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