**Procedure 913: Lease Accounting**

Category: Business Office, Procurement Office

Covered Individuals: Business Office Staff

Approved: 10/12/2022

##### **913.1 Lease Accounting Procedure General Statement:**

This procedure is to recognize and adopt the accounting and reporting requirements contained in Government Accounting Standards Board 87 (GASB 87) which identifies the required reporting and notes disclosure standards to be applied in the annual audited financial statements. The accompanying procedures details the required information to be reported including the manner and details of the information as it pertains to our financial reports.

##### **913.2 Lease Accounting Procedures:**

**Lease Definition:**

Per GASB 87, a lease is defined as a contract that conveys control of the right to use another entity’s nonfinancial asset as specified in the contract for a period of time in an exchange or exchange-like transaction. In addition, leases of the following asset types are not considered leases for the purpose of this policy, and are exempt:

* Leases of intangible assets
* Leases of inventory
* Leases of biological assets
* Supply contracts

In addition, Short Term leases (a lease with a term of less than one year including all options to extend the lease term regardless of their probability of being exercised) and leases that transfer ownership are exempt from this policy.

**Leases That Transfer Ownership:**

A lease that transfers ownership of the underlying asset is only exempt from the lease Accounting Policy when the transfer of ownership is implied in the terms of the lease (i.e. an option to purchase the leased asset at the end of the term for $1). A lease with a discounted purchase option is also included in this definition only if it is the expectation of both parties at the entry of the lease that the Lessee will exercise this option. In effect, the lease is acting as a financed purchase of an asset, and it will be accounted for as such. This also generally includes leased assets that require installation which will be prohibitively expensive to remove at the end of the lease term.

A lease with a purchase option at Fair Market Value at the end of the lease term DOES NOT meet this definition, and it is still considered a lease.

As a general rule, CEI will avoid leases that do not transfer ownership at the end of the lease term.

**Categorization/ Consolidation of Leases:**

Leases that share a type of underlying asset and similar terms are to be categorized together. For example, all leases of copiers are in one category because all of them were leased for 4 or 5 years and, while the make and model of each piece of equipment vary slightly, they share a core function or role.

In addition, if more than one lease within one category is entered into in the same month with the same term (meaning the leases both start and end in the same month as the other) these leases are effectively combined into one lease on record. The start date and end date for the consolidated lease are that of the first of the leases that were consolidated. For example, if two copier leases were entered in April of 2015 with a 60-month term, and one lease began on the 15th while the other started on the 24th, the start date of record for the consolidated lease would be April 15th.

**Lease Significance Test:**

GASB 87 requires that all leases are represented on the Balance Sheet in the form of a Right of Use Asset (Lease Asset) as well as a Lease Liability unless the lease is considered a Financed Asset or Short-Term Lease. This change in reporting was made to ensure that leases that do not transfer ownership but do constitute a multi-year commitment of funds (previously referred to as Operating Leases) do not fail to appear on the Balance Sheet as a long-term liability. Previously, there was no requirement to include Operating Leases on the Balance Sheet, which potentially allowed government entities to underrepresent their long-term obligations.

For CEI, this would mean that additional time and effort would be necessary to properly report on our leases. Due to the relatively small number of leases CEI enters, CEI has established a Significance Test to avoid the unnecessary time and effort required by implementing GASB 87 in full, without any substantial effect on CEI’s financial standing on the Government-Wide Statement of Net Position.

When CEI enters a lease as a lessee, the Present Value of the liability is calculated. This is accomplished by finding the sum of all expected payments to be made and adding in any relevant taxes. Then, the lease is categorized as described above in the section of the Lease Policy named Categorization/ Consolidation of Leases. The Present Values of all leases within each category are then combined, and measured against the Significance Threshold, which has been set by the Controller at $150,000.

The Controller has recognized that an additional $150,000 of long-term liability would not have any substantial effect on the appearance of the financial well-being of CEI. In other words, Financial statements that include an additional $150,000 in long-term liabilities tied to copier leases would not present a substantially different picture of CEI compared to one that did not mention it. No more than two lease categories may be deemed Insignificant in one fiscal year.

When a category of leases fails to meet the Significance Threshold, then all of the leases included in that category may be accounted for as if they were Operating Leases as described in older regulations, where they only appear on the income statement as Lease Expenses without any mention of the long-term obligation. The Controller maintains the discretion to record the long-term obligations of leases that do not meet the Significance Threshold alongside other long-term liabilities. If a single lease’s present value is substantial, but the category it occupies isn’t enough to meet the Significance Threshold in aggregate, the Controller may elect to record this lease as a Capital Lease as described in the next section.

If the sum of the present values from all leases within a category exceeds the Significance Threshold of $150,000, then the Lease Liability and Lease Asset will be recorded alongside those of other Capital Assets. The method of calculating the value of the liability and asset for each lease can be found under the Lessee Policy Section.

If a lease is added into a lease category, and the total present value of the lease increases to be close to the Significance Threshold without exceeding it, it is recommended that this new lease be recorded as a long-term asset. For example, if a new lease is added and the lease category’s total present value increases from $110,000 to $145,000, this lease should be accounted for like a long-term asset and liability to be amortized. This is ultimately to be done at the discretion of the Controller, to ease the transition from an insignificant category to a significant one.

If a lease category transitions from insignificant to significant, all leases within that category must be accounted for as capital assets as outlined above. For this reason, the present value of all leases must be recalculated annually. Once a lease has been accounted for as a capital asset, it will be accounted for as such for the remainder of its life. For every year the lease is considered significant, all leases entered in that year are accounted for as capital assets for the rest of its useful life. If the lease category’s aggregate present value of payments drops below the Significance Threshold in subsequent years, then any leases entered in that year of transition are not considered significant and are not tracked as long-term assets.

**Lessee Procedure:**

When CEI enters into a lease as a lessee, a Lease Liability and a Right of Use Asset are recorded on an internal Capital Asset tracking sheet. In CEI’s accounting software, the lease will not appear until a payment is made. When a payment is made, the expense will be debited to both Lease Expense and Interest Expense.

**Lease Liability:**

The Lease Liability is valued as the present value of all payments due for the lease, including relevant use tax and any incentives CEI will take advantage of, discounted by the interest rate explicit in the lease agreement or the implicit interest rate where the explicit interest rate is not stated. In the absence of the explicit rate and the information to calculate the implicit rate, the Incremental Borrowing Rate is used.

In the above paragraph, Payments Due only include fixed payments and any variable payments that are fixed in substance which can be accurately forecasted. If an exercise option is reasonably certain to be taken, the penalty or price of this option is to be included on the NPV schedule when it is to be leveraged.

Variable payments dependent on the performance of the lessee are not to be included in the liability valuation, but they are to be accounted for as lease expenses as they are incurred.

The implicit interest rate is the calculated rate of return necessary for the present value of the lease (The market price of the leased asset at the time the lease is started) to equal the future value (Sum of all payments) over the indicated number of periods. This calculation requires the market value of the leased asset at the beginning of the lease term to be stated in the lease, which is not common.

If the market value of the asset is not listed in the lease agreement, then the Incremental Borrowing Rate will be used to discount the lease. For Bonneville, the IBR will match the Diversified Bond Fund Interest Rate for the first month of the lease. This will be applied regardless of the term of the lease.

In effect, the total amount of the lease payments less the designated interest portion becomes the value of the Lease Liability. The total value of the designated interest portion is to be divided by the number of payments required by the lease. This will be the amount of each payment to be accounted for as an Interest Expense as each payment is made. The remainder will be considered a Lease Expense.

**Right of Use Asset/ Lease Asset:**

The Right of Use Asset is valued as the sum of the Lease Liability, the payments made to the lessor before or on commencement of the lease net of any incentives, and the initial direct costs necessary to place the leased asset into service.

Amortization of the Lease Asset should be done uniformly in equal amounts until the end of the useful life of the underlying asset. CEI uses the straight-line method, assuming that the value of the right-of-use asset at the end of the lease will be zero. leases will be amortized using the same Capital Asset Master Sheet used for the depreciation of other capital assets like buses and buildings.