

## FIN-6.07 - Leases

Administrative Rules Adopted by CAO (ARC)

Policy category

Accounting Administrative Rules

Policy number

FIN-6.07

### **LEASES**

Administrative Rule Adopted by CAO

ARC-FIN-6.07

#### **Purpose**

The purpose of this administrative rule is to establish minimum standards for payment, collection and reporting of leases in accordance with Governmental Accounting Standards Board, "GASB", Statement No. 87, Leases and its amendments.

#### **Lessee agreements**

GASB 87 requires that the City reports lease liabilities and the assets underlying the lessee obligations. Leased Right-of-Use assets are reported on the Statement of Net Position and are amortized over the life of the lease. Lease liabilities are reported at the present value of future payments and are adjusted over time by interest and payments. For modified accrual they are initially recorded as capital outlay and proceeds of lease contracts, and thereafter are recorded as principal and interest payments.

#### **Lessor agreements**

GASB 87 requires that the City reports lease receivables and deferred inflows underlying lessor obligations. The lease receivable and related deferred inflow amortize over the life of the contract and are reported the same for both GAAP full accrual and modified accrual basis of accounting. Through the life of the contract inflows are broken down into lease revenue and lease interest income.

The City has chosen not to implement GASB 87 for the budgetary basis of accounting. For the budgetary basis the City will report inflows of cash for lessor leases and outflows of cash for lessee leases. Leases that don't qualify as GASB 87 leases will report inflows of cash for lessor leases and outflows of cash for lessee leases.

#### **Authority**

Authority for this administrative rule is established in the City Charter and City Code. This administrative rule has been approved by the CAO.

#### **Monitoring**

The Accounting Division of the Bureau of Financial Services of the Office of Management and Finance (Accounting Division) will periodically monitor bureau compliance with the minimum standards of this rule. As instances of non-compliance are identified, bureaus will be required to develop and implement a corrective action plan. The Accounting Division will assist bureaus, if requested, to develop this plan. The Controller will report all instances of non-compliance annually to the Chief Financial Officer (CFO) and City Council.

#### **Definitions**

"Lease" as defined in GASB 87, is a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified by the contract for a period of time in an exchange or exchange-like transaction.

"Lessor" means the owner of leased property.

"Lessee" means the individual who pays a fee to the lessor to use real or personal property.

"Short-term lease" means a lease that, at inception it has a maximum possible term of 12 months (or less), including any known options to extend.

"Lease modification" is an amendment to the lease (such as a contract price change, lease term increase or decrease, and adding or removing an underlying asset. In accordance with GASB 87, modifications treated as a separate lease if the modification both the conditions below are met:

"a. the modification gives the lessee an additional lease asset by adding one or more underlying assets that were not included in the original lease contract.

b. The increase in lease payments for the additional lease asset does not appear to be unreasonable based on (1) the terms of the amended lease contract and (2) professional judgment, maximizing the use of observable information (for example, using readily available observable stand-alone prices)."

"Lease termination" is an amendment in which the lessee's right to use the underlying asset decreases.

"Rent" means a fee paid to the owner of property for the use of that property for a specified time period.

"Valuated" means that, when using the CLM module in SAP, either the lease has the right of use asset and full liability (lessee) recorded or the lease recognized a receivable and deferred inflow (lessor).

### **Lease Authority**

A lease is a contract and must be in writing.

A lessee lease must comply with purchasing laws outlined in City Code 5.33.030, and debt management policies outlined City policy FIN-2.12.II (D). A lessor lease must comply with City Code 3.15.080 (C).

### **Criteria for Identifying Leases**

Any contract that meets the above-referenced definition of a lease.

**A lease is GASB 87 relevant and will be valuated, unless it meets any of the following exceptions:**

- Any lease that meets the definition of short-term (such as month-to-month leases).
- Any lease that contains language allowing either party to cancel the lease. A true cancellation clause allows both the lessee and lessor to terminate the lease at any time for any reason. A clause specifying the cancellation of the lease due to non-appropriation of funds does not eliminate the possibility that the lease is a lease.
- Any lease whose underlying asset includes:
  - Intangibles (for example mining rights, patents, software, copyrights) except when the intangible asset is a right-to-use asset in a sublease agreement
  - Biological assets (for example timber, plants, and livestock)
  - Inventory
  - Service concession arrangements
  - Assets financed with outstanding conduit debt (unless the lessor reports both the asset and outstanding conduit debt); and
  - Supply contracts or Purchase Agreements
- Any lease that transfers ownership of the asset to the lessee by the end of the term and lacks termination options (besides funding or cancellation clauses).

- From a Lessor position, leases in which the underlying asset is an investment, as well as some regulated leases (such as airport-airline agreements).

-The lease contains a bargain purchase option. A bargain purchase option exists when the lessee can exercise a provision in the lease to purchase the leased property for a price sufficiently lower than the expected fair value of the property, and the exercise of this option at the inception of the lease is reasonably assured.

If a lease is not exempt as defined above, then it is GASB 87 relevant, and a candidate for recognition and measurement.

For non-valuated leases (non-GASB 87-relevant) leases, in either the lessee and lessor position, short-term lease payments are recognized as outflows of resources (i.e. expenditures) or inflows of resources (i.e. revenues), respectively, depending on the payment requirements per the lease.

### **Lease Accounting**

When a lease meets the criteria for recognition and measurement, they are accounted for in accordance with the following scenarios.

### **Lessee Accounting**

At inception, the Lessee recognizes an intangible right-to-use asset and liability.

The right-to-use the underlying asset is initially recorded at the amount of initial measurement of the lease liability plus prepayments (less any lease incentives received prior to lease commencement) and initial direct costs that are ancillary to place asset into service. The liability is recorded at the present value of future lease payments. Future lease payments include fixed payments, variable payments based on index or rate, reasonably certain residual guarantees, etc.). In accordance with GASB 87, paragraphs 21 and 22:

#### **“Lease Liability:**

21. A lessee initially should measure the lease liability at the present value of payments expected to be made during the lease term. Measurement of the lease liability should include the following, if required by a lease:

- a. Fixed payments
- b. Variable 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 as of the commencement of the lease term
- c. Variable payments that are fixed in substance (as discussed in paragraph 22)
- d. Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees
- e. The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option
- f. Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause
- g. Any lease incentives (as discussed in paragraphs 61 and 62) receivable from the lessor
- h. Any other payments that are reasonably certain of being required based on an assessment of all relevant factors. The lease liability excludes any payments whose nature is dependent on the lessee’s performance or usage of underlying asset.

22. Variable payments based on future performance of the lessee or usage of the underlying asset should not be included in the measurement of the lease liability. Rather, those variable payments should be recognized as outflows of resources (for example, expense) in the period in which the obligation for those

payments is incurred. However, any component of those variable payments that is fixed in substance should be included in the measurement of the lease liability.”

Future lease liability payments are discounted using the City’s incremental borrowing rate provided by the Debt Management Division and maintained by the Accounting Division.

Subsequently, an asset is amortized over the shorter of its useful life or lease term, and a liability is reduced by lease payments made, less interest expense.

### **Lessor Accounting**

When in the lessor position, the lease is initially recorded as both a lease receivable (generally including same items as lessee liability) and a deferred inflow of resources. The deferred inflow is recorded in an amount equal to the sum of the lease receivable and any payments received prior/up to the lease commencement which relate to a future period.

Subsequently, an asset is depreciated, and the receivable is reduced by lease payments made (less portion of accrued interest). The Accounting Division will maintain the interest rate to be used. In the event this results in an adjustment that exceeds the asset’s carrying value, then the difference is recognized in the flows statement. In the event of asset impairment, GASB 42 shall apply to the right-to-use lease asset.

### **Remeasurement**

In accordance with GASB 87, Lease Modifications and Terminations:

“An amendment to a lease contract should be considered a lease modification, unless the lessee’s right to use the underlying asset decreases, in which case it would be a partial or full lease termination. A lease termination should be accounted for by reducing the carrying values of the lease liability and lease asset by a lessee, or the lease receivable and deferred inflows of resources by the lessor, with any difference being recognized as a gain or loss. A lease modification that does not qualify as a separate lease should be accounted for by remeasuring the lease liability and adjusting the related lease asset by a lessee and remeasuring the lease receivable and adjusting the related deferred inflows of resources by a lessor.”

In both the lessee and lessor positions, the lease term will be reassessed only if an option which was previously determined to be reasonably exercised (or not exercised), changes. (ref GASB 87 paragraphs 15 a b).

### **Discount Rate**

The discounts rate will be determined by the OMF-Accounting division and updated periodically; at least annually.

### **For accounting issues not addressed in the GASB standard, the following policies have been adopted.**

Leases with amendments to extend each year and lack an option to extend are treated as short-term leases and are not relevant for valuation.

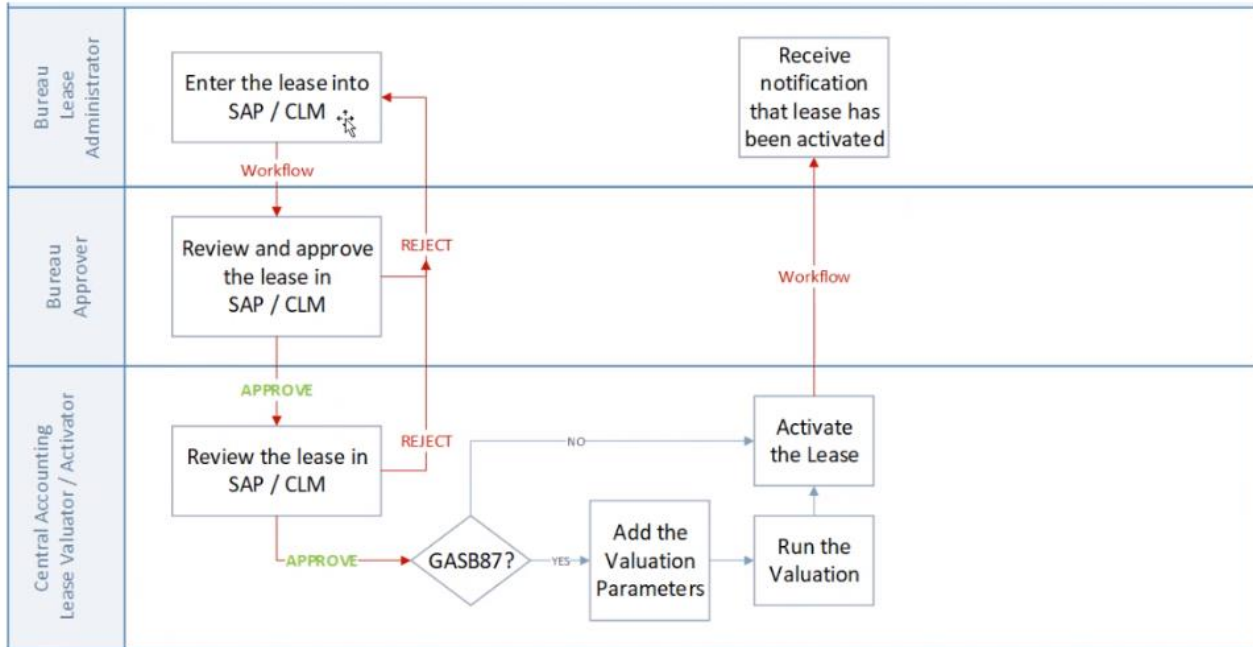
Leases with future rent increases based on more than one benchmarks (such as a fixed percentage amount, market comparability rates, percentage amount based on the future performance of CPI, or other index, etc.) will be analyzed individually for language describing the comparison. Language that bases future rent increases on multiple benchmarks will be valued using the benchmark which is fixed or reasonably certain (if any).

### **SAP Contract Lease Management “CLM” Workflow**

Leases (regardless of relevancy to GASB 87) are managed and maintained through the Contract Lease Management module (“CLM”), within the SAP system. Certain agreements may qualify for an exception from being input and managed via the CLM module. These exceptions may include (but are not limited to): ongoing price agreements for day-to-day rentals, certain easements which do not provide exclusive rights over the land the asset rests on (commonly, temporary

construction, temporary access for soil samples or otherwise), interagency leases, and Housing residential lease agreements that are managed by Home Forward and have terms of 12 months or less. The Accounting Division may authorize an exemption from CLM input if a lease does not meet the GASB 87 definition of a lease. All other considerations for exception from CLM input must go directly through the Controller for approval. The Accounting Division will maintain a list of these exceptions.

The three major roles in the CLM workflow are: Administrator, Approver, and Valuator. See diagram, below.



The Administrator is responsible for uploading a copy of the contract into SAP and entering the lease inputs with a note in SAP documenting the renewal likelihood for all future renewal options, the Approver is responsible for reviewing and approving the lease inputs, and the Valuator is responsible for reviewing the inputs, GASB 87 relevance, lease valuation and activation of the lease in the system. No postings will occur until the lease approver and lease valuator have approved the lease.

For leases which are allocated over more than one fund, the Accounting Division should be consulted before journal entries are posted. For leases needing corrections to the fund, the lease Valuator is responsible for oversight of correcting journal entries.

### Responsibility for Reporting

Accounting Division shall provide bureau staff training, further define binding procedures to comply with this policy, and support bureaus to use the SAP solution.

The Controller (or delegate) provides final interpretation of this policy.

The Controller has authority to remove SAP roles from anyone determined to not be complying with this policy.

Technology Services shall support the SAP system solution and ensure all system changes are approved by the Controller (or delegate). Also, ensure Accounting and bureau requirements are met and support an overall process perspective.

Directors ensure bureau compliance with this policy and timely completion of related schedules to the Accounting Division (i.e. audit schedules).

Bureau staff are required to complete required training, seek direction from the Accounting Division on untrained/complicated entries/agreements/changes, voice concerns to the Accounting Division and/or your bureau SAP Change Agent to increase overall process effectiveness.

**History**

Resolution No. 36248, originally adopted by Council September 1, 2004.

Revised by Resolution No. 36435, adopted by Council September 6, 2006.

Revised June 2023, approved by the CAO.

\_\_\_\_\_ June 20, 2023  
Michael Jordan, CAO Date