# GASB 87 Lease Policy

## I. Authority

The Fort Worth City Council is responsible for legislation, policy formulation, and setting the overall direction of government. This includes the approval of financial policies which establish and direct the operations of the City of Fort Worth (“City”). The City Manager is responsible for carrying out the policy directives of the City Council and managing the day-to-day operations of the executive departments, including the Financial Management Services Department (“FMS”). This policy shall be administered on behalf of the City Manager by the Chief Financial Officer/Director of FMS (“CFO”).

## II. Purpose

This policy defines and provides the guiding principles with respect to the financial management of leases and subscription-based information technology arrangements (“SBITAs”) for the City. The objectives of this policy are to ensure consistent practices in accordance with Generally Accepted Accounting Principles (“GAAP”) and applicable regulatory agencies in the setting up and reporting of leases meeting the Governmental Accounting Standards Board (“GASB”) standards. Controls are created to establish, maintain, and enforce a sound system of operational procedures and internal control objectives. These controls address the decentralized nature of the processes associated with leases and SBITAs while also providing standards and acceptable controls for these activities.

## III. Applicability and Scope

All employees of the City, including uniformed employees in positions who are responsible for performing fiscal operations described herein, shall apply the principles of this policy. This may include, but not be limited to, staff who enters into a lease and/or SBITA, receives right to use assets and monitor use. Further, this policy shall cover all funds and right of use assets under the fiscal control of the City Manager, Mayor and City Council.

## IV. Glossary

See definitions related to this policy provided in the Glossary for Financial Management Policy Statements.

## V. General Information

This policy utilizes the definition of a lease as defined under GASB Statement 87, as a contract or agreement which conveys control of the right to use another entity’s nonfinancial asset (the underlying asset) as specified in the contract/agreement for a period of time in an amount equivalent to the value of the asset. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any agreement that meets this definition will be accounted for under the lease guidance, unless specifically excluded.

Under GASB Statement 96, a SBITA is a contract or agreement which conveys control of the right to use another party's IT software alone, or in combination with tangible capital assets (underlying IT assets), as specified in the contract/agreement for a period of time in an exchange or exchange-like transaction, for an amount equivalent to the value of the asset. Any agreement that meets this definition will be accounted for under the lease guidance, unless specifically excluded.

A. Lessee Accounting

1. A lessee will 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.
2. The lease liability will be measured at the present value of payments expected to be made during the lease term (less any lease incentives). The lease asset will 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.
3. A lessee will reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee will 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.
4. The notes to financial statements will include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

B. Lessor Accounting

1. A lessor will 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.
2. A lessor will not derecognize the asset underlying the lease. The lease receivable will be measured at the present value of lease payments expected to be received during the lease term.
3. The deferred inflow of resources will 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.
4. A lessor will 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.

5. The notes to financial statements will include a description of leasing arrangements and the total amount of inflows of resources recognized from leases.

C. Regulated Leases

1. A regulated lease is one in which external laws, regulations, or legal rulings establish ALL of the following:

    a. Lease rates cannot exceed a reasonable amount (reasonableness subject to determination by an external regulator).

    b. Lease rates will be similar for lessees that are similarly situated.

    c. Lessor cannot deny potential lessees right to enter into leases if facilities are available (lessee's use of the facilities has to comply with generally applicable use restrictions).

2. Aeronautical use:

    a. "… any activity that involves, makes possible, is required for the safety of, or is otherwise directly related to the operation of aircraft. Aeronautical use includes services provided by air carriers related directly and substantially to the movement of passengers, baggage, mail and cargo on the airport.

    Persons, whether individuals or businesses, engaged in aeronautical uses involving the operation of aircraft, or providing flight support directly related to the operation of aircraft, are considered to be aeronautical users.

3. Nonaeronautical use:

    a. Any activities not associated with the direct transport of passengers or cargo. Such activities generally involve the operation of facilities that do not need to be located at an airport, including airline headquarters and reservation centers; flight kitchens; hotels; public parking, and rental car operations.

D. Software Based Information Technology Arrangements

1. The SBITAs have a subscription term which would include the period during which the City has a noncancelable right to use the underlying IT assets and would include periods covered by an option to extend (if it is reasonably certain the government or SBITA vendor will exercise that option) or to terminate (if it is reasonably certain the government or SBITA vendor will not exercise that option). At the subscription's commencement, the City will assess all relevant factors to determine the likelihood of exercise options, whether contract-based, asset-based, market based, or

government-specific. The following factors will be considered in evaluating the likelihood of option exercise: A significant economic incentive, such as favorable contractual terms and conditions for the optional periods compared with the current market.

2. A potential change in technological development that significantly affects the technology used by the IT asset.

3. A potential significant change in the government's demand for the SBITA vendors' IT assets.

4. A significant economic disincentive, such as costs to terminate the SBITA and sign a new SBITA, i.e., negotiation costs, costs of identifying another suitable IT asset or another suitable SBITA vendor, implementation costs. or a substantial cancellation penalty.

5. Option exercise history.

6. The extent to which the SBITA's IT assets are essential to the provision of government services.

A rolling month-to-month SBITA or a SBITA that continues into a holdover period until a new contract is signed would not be enforceable if both the government and the SBITA vendor have an option to terminate and either could cancel the SBITA at any time. Provisions that allow for termination of a SBITA as a result of either payment of all sums due or default on subscription payments are not considered termination options.
A fiscal funding or cancellation clause allows the City to cancel a SBITA typically on an annual basis if the government does not appropriate funds for the subscription payments. That type of clause will affect the subscription term only if it is reasonably certain that the clause will be exercised.

## VI. <u>Responsibility/Authority</u>

A. City-wide Department responsibilities

1. Serve as custodians of right of use assets that are assigned to their departments.
2. Ensure full departmental compliance with the established lease policy in order to maintain adequate records of the City's right of use assets.

3. Department designee responsibilities include but are not limited to:

   a. Identifying potential new leases

   b. Notify FMS of any change or cancellation to a lease

c. Marking the Mayor and Council Communication (M&C) as a potential lease

d. Including the Finance Lease Coordinator in the collaboration of the M&C

e. Having the Purchasing module designate the contract as a lease

f. Emailing the Finance Lease Coordinator providing all information needed to determine eligibility and when none of the above would apply

B. FMS responsibilities

1. The Financial Reporting Lease Coordinator shall ensure that all leases entered into by the City are properly identified, recorded and reconciled in the Leasing software, Purchasing, and PeopleSoft General Ledger (PSGL) modules monthly.

2. Maintain a master lease & subscription spreadsheet to determine the lease type (short-term, scope exclusion or GASB 87/96).

3. Complete the entry of the lease details in the Leasing software once the lease type is determined to be GASB 87/96 or Regulated leases.

4. The Financial Reporting Lease Coordinator must oversee the review of all transactions related to leased assets at least monthly and update the Leasing software, and PSGL system as required, upon validation of the transactions or corrections.

5. FMS is responsible to provide department representatives with the necessary training in lease asset management to effectively fulfill their duties and responsibilities under this policy.

## VII. <u>Asset Classification</u>

The City categorizes capital assets into the following:

A. Land Lease

B. Building Lease

C. Infrastructure Lease

D. Machinery and Equipment Lease

E. Vehicle Lease

F. Parking

G. Airport Hangar

H. Intangibles (SBITAs)

## VIII. Capitalization

A. Capitalization Thresholds

1. Land must be capitalized regardless of the value or cost.
2. Buildings must be capitalized regardless of the cost.
3. Infrastructure must be capitalized when the useful life is 3 years or greater and the cost is $100,000 or more for the life of the lease.
4. Machinery and Equipment qualifying as a capital asset is defined as a single item with an acquisition cost of $25,000 or more and has a useful life of two years or greater. This includes items designed for off road for the life of the lease.
5. Vehicles must be capitalized when the useful life is 4 years or greater, the cost is $5,000 or greater for the life of the lease and it meets both of the following criteria:
   a. Self-propelled
   b. Primary use is on public streets and the unit is street legal
6. Furniture, fixtures, and equipment (FF&E) will not be capitalized no matter the amount.
7. Bulk machinery and equipment per lease contract will be capitalized if the total amount is over $500,000 for the life of the lease.
8. Intangible assets - SBITAs must be capitalized when the term of the agreement is greater than 12 months and the cost is greater than $100,000 for the agreed term.

## IX. Amortization

A leased asset will be amortized in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The amortization of the leased asset will be reported as an inflow or outflow of resources (for example, amortization expense), which may be combined with depreciation expense related to other capital assets for financial reporting purposes.

## X. Initial Measurement

A. Lease Liability

For all leases meeting the GASB standard, the lessee will record a lease liability. The lease liability will be measured at the present value of future lease payments expected to be made during the lease term and include the following:

1. Fixed payments which are payments established at specific amounts in the lease contract for which the lessee is obligated to make.

2. Variable payments that depend on an index or rate; such as the Consumer Price Index (CPI) or a market interest rate—initially measured using the index or rate as of the lease term’s commencement and assumed to stay in effect throughout the lease term.

3. Variable payments that are fixed in substance.
4. Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees (RVG).

5. The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option.

6. 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.

7. Any lease incentives receivable from the lessor.

8. Any other payments that are reasonably certain of being required based on an assessment of all relevant factors.

B. Lease Receivable

A lessor initially will measure the lease receivable at the present value of lease payments expected to be received during the lease term, reduced by any provision for estimated uncollectible amounts. Measurement of the lease receivable include the following:

1. Fixed payments.
2. Variable payments that depend on an index or rate, initially measured using the index or rate as of the lease term's commencement.
3. Variable payments that are fixed in substance.
4. RVG payments that are fixed in substance.
5. Any lease incentives payable to the lessee.

## XI. **Payments**

A. Types of Payments Relevant to Lease Accounting

1. Fixed payments.
2. Variable payments that depend on an index or rate, initially measured using the index or rate as of the lease term's commencement.
3. Variable payments that are fixed in substance.

B. Lessee Payments

Fixed rate payment is an unchanging rate charged on a liability, such as a loan or mortgage and receivable, such as a rent from a property owned. It might apply during the entire term of the loan or for just part of the term, but it remains the same throughout a set period.

Variable payment depends on the lessee's future performance or usage of the underlying asset do not have a baseline measurement at lease term commencement and are excluded from the initial liability, e.g., copier lease payments contingent on copier usage or rental car payments dependent on miles incurred. However, any minimum guarantee amounts or other portions of variable payments that are fixed in substance, i.e., they can be readily measured, are to be included in the lease liability.

C. Lessor Payments

Fixed rate payment will record a lease receivable and recognize inflows of resources, e.g., revenue, at the time a not-fixed-in-substance RVG's 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 purchase option or penalty for lease termination will be recognized as a receivable and an inflow of resources, e.g., revenue, when those options are exercised.

Variable payments will be recognized as inflows of resources, e.g., revenue, in the period to which those payments relate. Examples include variable payments based on a percentage of airport terminal restaurant sales or vendor stall sales at government-owned sports stadiums.

## XII. Discount Rate

The discount rate is applied to all leases that meet the GASB standards set out in this policy.

A. Lessee Discount Rate

The lessee discount rate is established by using the interest rate at which time the transaction is made which may be the rate implicit in the lease contract. Consistent with current guidance, if the lease's implicit interest rate is not readily determinable within the contract, the City's estimated incremental borrowing rate will be used. Determining the incremental borrowing rate entails estimating the interest rate the Lessee would be charged for borrowing the lease payment amounts during the lease term.

B. Lessor Discount Rate

The lessor discount rate will be determined by the interest rate that is charged to the lessee including implicit rates and will use this rate to discount the future lease payments. If the contract does not include a stated interest rate, a calculation, of the implicit interest rate, will need to be performed. The City will need a market value for the related property. A valuation specialist might be needed to apply a cost, income or market approach or some combination of these approaches to arrive at a lease's supportable implicit rate.

The discount rate will only be updated and receivable or payable remeasured if there is a change in the lease term or interest rate the lessor charges the lessee, provided the changes individually or in the aggregate are expected to significantly affect the lease receivable or payable amount. At that time, the receivable or payable will be remeasured using the revised rate. The deferred inflow and outflows of resources balance generally will be adjusted by the same amount as any changes resulting from remeasurement of the lease receivable or payable.

## XIII. Remeasurement/Modification

A. Criteria

The lease liability/receivable will be remeasured at subsequent reporting dates if one or more of the following occurs, presuming the changes individually or in the aggregate are expected to significantly affect the lease liability/receivable since the last measurement:

1. The lease term changes.

2. Based on an assessment of all relevant factors, the likelihood of a residual value guarantees being paid or purchase option being executed changes from “reasonably certain” to “not reasonably certain” or vice versa.

3. The estimated remaining payments change from the amount included in the lease liability/receivable measurement.

4. The rate the lessor charges the lessee changes, if used as the initial discount rate.

5. Remeasurement is required when a contingency upon which some or all of the variable payments expected to be made over the lease term’s remainder are based is resolved such that those payments meet the criteria for inclusion in the lease liability/receivable, i.e., an event occurs causing variable payments contingent on the underlying asset’s performance or use has occurred, causing the payments to become fixed or fixed in substance.

6. If remeasurement is triggered, the liability/receivable also must be adjusted for changes to the index or rate used to determine variable payments, if the change is expected to significantly affect the previous measurement’s liability/receivable amount. Changes in an index or rate used to measure variable payments do not in and of themselves require liability/receivable reassessment.

   The lessee is not required to remeasure the lease liability/receivable or reassess the discount rate solely because of changes in its incremental borrowing rate.

7. Lessees will adjust the lease asset by the same amount as the corresponding lease liability, except if the lease asset’s carrying value is reduced to zero. If this occurs, any remaining amount will be reported in the resource flows statement as a gain.

For additional information or questions concerning this policy, please contact the FMS GASB 87/96 Core Team at: FIN_FINANCIAL_REPORTING@fortworthtexas.gov.