State of Arizona Accounting Manual

INTRODUCTION

Beginning in fiscal year 2022, leases are no longer classified as operating or capital. Leases are financings of the right to use an underlying nonfinancial asset and are now categorized as short-term, contracts that transfer ownership (financed purchase), and all other leases.

A lease is 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.

The accounting treatment of short-term leases and all other leases is discussed within this policy. Contracts that transfer ownership are discussed in SAAM Topic 2545.

POLICY & PROCEDURES

1. Leases that are either existing or entered into on or after July 1, 2021, must be evaluated, and if required, tracked and reported in the ACFR. This includes leases where the State is the lessee or the lessor and leases previously categorized as operating leases or capital leases.

2. A lease is 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.

2.1. A nonfinancial asset is an asset that derives its value from its physical traits. Nonfinancial assets include land, buildings, vehicles, and equipment.

2.2. A financial asset is a liquid asset that gets its value from a contractual right or ownership claim. Financial assets include cash, stocks, bonds, mutual funds, and bank deposits.

2.3. The contract must be legally enforceable.

2.4. A contract conveys control of the right to use the underlying asset if it has both of the following:

2.4.1. The right to obtain the present service capacity from the use of the underlying asset as specified in the contract; and

2.4.2. The right to determine the nature and manner of use of the underlying asset specified in the contract. Control does not have to be uninterrupted, but to convey control, the lease must be exclusive (e.g., a school building lease for only nine months of the year for five years does meet the control definition). If a lease is provided to two separate entities that share the same asset, this does not convey control of the asset to the lessee, as neither controls the present service capacity but must instead share it (e.g., a grazing lease to two separate bordering ranches on the same parcel of land).

2.5. A lease must be for a specified period of time. The present value can only be calculated if a beginning and end date are defined in the contract. As a result, “permanent” leases or leases without a beginning and ending date are excluded from the scope of the lease accounting requirements.

2.6. A transaction is exchange or exchange-like when each party in the contract receives or gives up essentially equal value (e.g., if a parcel of land with market rent of $100,000 per year is leased to the State for $1 per year, this would NOT be an exchange or exchange-like transaction.)

3. Leases that are **excluded** from reporting under GASB 87 include:

3.1. Short-term leases. A short-term lease is a lease whose **maximum** possible term is twelve (12) months or less including any options to extend, regardless of their probability of being exercised. Do not include any lease periods that are cancelable by BOTH the lessee and the lessor (e.g., a rolling month-to-month lease or holdover period until a new lease contract can be negotiated).

3.2. Leases that transfer ownership. If a lease automatically transfers ownership to the lessee at the end of the lease, it is a **financed purchase** and should be accounted for as a capital asset and loan, not as a lease. If, however, a lease contract includes a **purchase option**, the transfer of ownership is not assured and, therefore, it must be considered a GASB 87 lease until the option is actually exercised. When the option is exercised, the lease is terminated, and the intangible right-to-use lease asset should be transferred to a tangible capital asset.

3.3. Leases of intangible assets, including:

3.3.1. Rights to explore for or to exploit natural resources such as oil, gas, and minerals and similar nonregenerative resources;

3.3.2. Licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights; and

3.3.3. Licensing contracts for computer software. Subscription-based information technology arrangements (SBITA) will be discussed in a separate SAAM.

3.4. Leases of biological assets, including timber, living plants, and living animals.

3.5. Leases of inventory.

3.6. Contracts that meet the definition of a service concession arrangement in paragraph 4 of GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*.

3.7. 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.

3.8. Supply contracts, such as power purchase agreements.

3.9. Contracts for services except those contracts that contain *both* a lease component and a service component. For contracts that contain both, the lease component should be separated from the service component, and the lease component should be evaluated on its own merits as to whether it meets the definition of a lease.

3.10. Inter-agency leases, *unless* the agency meets certain criteria to be discretely presented in the State's Annual Comprehensive Financial Report (ACFR). Refer to Note 1 of the most recently issued ACFR for a current list of discretely presented component units.

3.11. Leases with total lease payments below the State's materiality threshold. If a lease is less than the State's material threshold, the lease should be recorded as a short-term lease recording the payments as an expense in the period when the payment is made (lessee) or revenue in the period the payment is received (lessor).

4. *Materiality Threshold.*

5. The State has determined that a materiality threshold for applying this policy shall be set at five hundred thousand dollars ($500,000). To determine if a particular lease meets the materiality threshold, the total lease payments to be received or paid must be calculated.

5.1. The fixed periodic payments and the fixed in-substance payments (in case of variable usage fees, there may be a minimum fee regardless of actual usage) should be added together, then multiplied by the total number of expected payments to be made per the contract. The expected number of payments includes any extensions in the contract that are reasonably certain to be exercised.

5.2. Any lease incentives that affect the fixed periodic fees or that are to be paid after commencement of the lease should be subtracted from the total.

5.3. For lessees, if a purchase option exists and the agency is reasonably certain it will be exercised, the price of the purchase option should be added to the total. Purchase options should only be added when the State is the lessee and not added if the State is the lessor.

6. If the total calculated lease payments to be paid or received is equal to or larger than the materiality threshold, the requirements within this policy must be followed when accounting for the lease.

7. If the total lease payments to be paid or received is less than the materiality threshold, then the lease must be recorded as a short-term lease recording the payments as an expenditure when paid or revenue when received.

8. *Lease term.*

9. The lease term is the period during which a lessee has a noncancelable right to use an underlying asset, *plus* the following periods, if applicable:

9.1. Periods covered by an option (by the lessee OR the lessor, not both) to extend the lease if it is *reasonably certain*, based on all relevant factors, that the lessee or lessor will exercise that option,

9.2. Periods covered by an option (by the lessee OR the lessor, not both) to terminate the lease if it is *reasonably certain* that the lessee or lessor will *not* exercise that option,

9.3. 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 excluded from the lease term.

9.4. Termination options do not include terminations due to purchase of an underlying asset, payment of all sums due, or default on payments.

10. A fiscal funding cancellation clause allows the State as lessee to cancel a lease (on an annual basis) if the State does not appropriate funds for the lease payments. This type of clause should only affect the lease term if it is *reasonably certain* that the clause will be exercised.

11. *Reasonably Certain.*

12. To determine if an action is "*reasonably certain,*" the lessee and the lessor should assess all factors relevant to the likelihood that the lessee or lessor will exercise an option, whether these factors are contract based, underlying asset based, market based, or government specific. Examples of factors to consider include, but are not limited to, the following:

12.1. Contract-based factors such as significant economic deterrents, including the cost to terminate the lease and sign a new one, negotiation costs, relocation costs, abandonment of significant leasehold improvements, costs of identifying another suitable underlying asset, costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location, or a substantial cancellation penalty.

12.2. Market-based factors such as whether contractual terms and conditions for the optional periods are favorable compared with current market rates.

12.3. Asset-based factors such as whether the asset underlying the lease is necessary for providing government services.

12.4. Government-specific factors such as the cost or timeliness of the procurement process or the likelihood to appropriate funds based on historical experience.

13. *Special Circumstances.*

14. Some leases or contracts are more complex and may have special circumstances such as contract combinations, contracts with multiple components, subleases, sale-leasebacks, or lease-leasebacks.

15. _Contract Combinations._

15.1. Contracts that are entered into at or near the same time with the same counterparty should be considered part of the same contract (and follow the guidelines above for contracts with multiple components) if either of the following criteria is met:

15.1.1. The contracts are negotiated as a package with a single objective; or

15.1.2. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

16. _Contracts with Multiple Components._

16.1. A contract may have *multiple components* such as a lease of equipment or office space, which also includes a service component such as janitorial services or maintenance on equipment. When a contract contains multiple components, the lease and nonlease components should be accounted for as separate contracts. However, if a contract does not include prices for individual components and it is not practicable to determine a best estimate for price allocation for some or all components in the contract, the components should be included as a single lease.

16.2. If a lease involves multiple underlying assets and the assets have different lease terms, the lessee and lessor should account for each underlying asset as a separate lease component. In addition, if the assets are in different major classes (even if the lease term is the same), the lessee (not lessor) should account for each underlying asset as a separate lease component.

16.3. For both instances listed above (lease and nonlease components or multiple assets), if the contract does not include prices for the individual components, and it is not practicable to determine a best estimate for price allocation of the separate components; or the prices appear to be unreasonable in the breakdown of the prices, the contract should be accounted for as a single lease. If multiple components are accounted for as a single lease unit, the accounting for that unit should be based on the primary lease component within the contract. For example, the main lease asset's lease term should be used if there are multiple lease terms.

17. _Subleases._

17.1. *Subleases* involve three parties: the original lessor, the original lessee (who is also the lessor in the sublease), and the new lessee. If the State is the original lessee and the lessor in the sublease, then the State should account for the original lease and the sublease as two separate transactions, as a lessee and a lessor, respectively. These two transactions should not be offset against one another.

17.2. Any sublease situation where the State has entered into a lease as a lessee and then as a lessor must be reported to the GAO for disclosure in the ACFR.

18. _Sale-Leaseback Transactions._

18.1. *Sale-leaseback transactions* involve the sale of an underlying asset by the owner and a lease of the property back to the seller (original owner).

18.2. A sale-leaseback transaction must include a transaction that qualifies as a sale to be eligible for sale-leaseback accounting treatment. If there is not a qualifying sale, the transaction should be accounted for as a borrowing activity by the seller-lessee and a lending activity by the buyer-lessor.

18.3. For qualifying sale-leaseback transactions, the sale and lease portions of the transaction should be accounted for as two separate transactions – a sale and a lease.

18.3.1. The sale is still connected to the lease as far as the timing of the recognition of the gain or loss: The difference between the carrying value of the capital asset that was sold and the net proceeds from the sale should be reported as a deferred inflow of resources (or a deferred outflow of resources) and subsequently recognized as gain or loss in a systematic and rational manner over the term of the lease.

18.3.2. However, if the lease portion of the transaction qualifies as a short-term lease, the gain or loss from the sale of the capital asset should be recognized immediately.

18.4. Any qualifying sale-leaseback transactions entered into by the State must be reported to the GAO for disclosure in the ACFR.

19. *Lease-Leaseback Transactions.*

19.1. In a *lease-leaseback transaction*, an asset is leased by one party (first party) to another party and then leased back to the first party. The leaseback may involve an additional asset (such as leasing a school building that has been constructed by a developer on land owned by and leased back to a school district) or only a portion of the original asset (such as leasing back only one floor of a building to the owner). This type of transaction should be accounted for as a net transaction.

19.2. However, both the lease and leaseback portions of the transaction should be tracked separately for disclosure purposes.

19.3. Any lease-leaseback transactions entered into by the State must be reported to the GAO for disclosure in the ACFR.

20. *Intra-Entity and Related Party Leases.*

20.1. When the lease is between two state agencies or a state agency and a blended component unit of the State, the transactions are eliminated and are excluded from reporting as a lease. If separate financial statements are issued for any of the individual agencies or blended component units, the classification and accounting should be the same as for similar leases between unrelated parties, however, the leases must be eliminated for the comprehensive state reporting. Lease arrangements between the State and discretely presented component units of the State (or between two discretely presented component units) should be treated in the same manner as any other lease under this policy.

20.1.1. As of FY2021, these are the only discretely presented component units and are *not* excluded from these guidelines (all other component units and state agencies are excluded):

20.1.1.1. Arizona Finance Authority

20.1.1.2. Arizona Power Authority

20.1.1.3. Rio Nuevo Multipurpose Facilities District

20.1.1.4. Arizona Commerce Authority

20.1.1.5. Department of Insurance and Financial Institutions Guaranty Funds (only funds ID2114 & ID2154)

20.1.1.6. Arizona Public School Credit Enhancement (APSCE)

21. *Lease Modifications and Terminations.*

22. Most cases of a lease modification will follow the guidelines described within the Lessee Accounting and Lessor Accounting sections. However, occasionally the change results in a new lease rather than a lease modification if both of the following conditions are present:

22.1. The lease modification gives the lessee an additional lease asset by adding one or more underlying assets that were not included in the original lease contract, and

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

23. ***Lease Determination and Reporting.***

24. To determine which leases must be reported as a lease, use the GASB 87 Decision Forms found on the GAO webpage under Resources, Leases (GASB 87) and complete the GASB 87 LESSEE and/or LESSOR Decision Forms.

25. All GASB 87 leases must be included within the ACFR and should be reported to the GAO ACFR group at ACFR@azdoa.gov. Agencies should report their GASB 87 leases either by submitting their audited financial statements using the accrual basis of accounting or using the Closing Package process located on the GAO website under Financials, ACFR, Closing Package Information.

26. Lessee Accounting Reporting and Forms.

27. When the State is the lessee, the State should recognize a lease liability and an intangible right-to-use capital lease asset (lease asset) at the commencement of the lease term.

28. If after completing the GASB 87 LESSEE Decision Form, it is determined that the contract is not a GASB 87 Lease, provide the required comments and explanation required on the Form and submit to ACFR@azdoa.gov. Payments made for non GASB 87 leases are expensed as the payments are made.

29. If after completing the GASB 87 LESSEE Decision Form, it is determined that the contract is a GASB 87 Lease, complete the GASB 87 LESSEE Collection Form for the appropriate fiscal year. This Form will calculate the Present Value and generate an amortization table for the planned activity of the lease. Note that the Leases Rates may vary from year to year. Therefore, the correct fiscal year Collection Form must be completed annually.

30. To report the actual lease activity and executed lease amendments or extensions for the lease that the GAO will need to compile the ACFR, complete the GASB 87 LESSEE Activity Form every year that the lease is active.

30.1. Use the information and tables from the GASB 87 LESSEE Collection Form to complete the general lease information and Expected Lease Payments section (left-hand side) on the GASB 87 LESSEE Activity Form for the appropriate fiscal year.

30.2. Enter Actual Lease Payment activity (right-hand side) on the GASB 87 LESSEE Activity Form. All payments made to the lessor should be reflected to include differences in timing, amounts, other charges and variable charges. Provide any additional information needed to explain any variances or changes.

30.3. If applicable, complete the Lease Modifications section of the Activity Form. Note that the Leases Rates may vary from year to year. Therefore, the correct fiscal year Activity Form must be completed annually.

31. *Lease Modifications-Lessee.*

32. There are certain actions that could occur during the lease term that will require the lease liability and lease asset to be remeasured if the changes individually or in the aggregate are expected to *significantly* affect the amount of the lease liability since the previous measurement. These actions include:

32.1. A change in the lease term (e.g. an extension or termination).

32.2. A change from reasonably certain to not reasonably certain or vice versa for a purchase option or residual value guarantee being paid.

32.3. A change in the estimated amounts for payments already included in the measurement of the lease liability. A lease liability is not required to be remeasured solely for a change in an index or rate used to determine variable payments, but would be required if multiple actions occurred (e.g., adding an extension as well as a change in the estimate due to a change in an index or rate).

32.4. A change in the interest rate the lessor charges the lessee, if used as the initial discount rate.

32.5. A contingency, upon which some or all of the variable payments that will be made over the remainder of the lease term are based, is resolved such that those payments now meet the criteria for measuring the lease liability (e.g., an event occurs that causes variable payments that were contingent on the performance or use of the underlying asset to become fixed payments for the remainder of the lease term).

32.6. If the lease had extensions or other amendments exercised, complete the Lease Modifications section of the GASB 87 LESSEE Activity Form. The GAO will use this section to determine what steps will be necessary for the correct reporting of the Lease in the ACFR.

33. Submit all three forms, the GASB 87 LESSEE Decision Form, GASB 87 LESSEE Collection Form for FYXXXX, and GASB 87 LESSEE Activity Form for FYXXXX to ACFR@azdoa.gov no later than the due date published for closing package submissions.

34. Lessor Accounting Reporting and Forms.

35. When the State is the lessor, the State should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term.

36. If after completing the GASB 87 LESSOR Decision Form, it is determined that the contract is not a GASB 87 Lease, provide the required comments and explanation required on the Form and submit to ACFR@azdoa.gov. Payments made for non GASB 87 leases are recorded as revenue as the payments are received.

37. If after completing the GASB 87 LESSOR Decision Form, it is determined that the contract is a GASB 87 Lease, complete the GASB 87 LESSOR Collection Form for the appropriate fiscal year. This Form will calculate the Present Value and generate an amortization table for the planned activity of the lease. Note that the published applicable FY rates may vary from year to year, therefore the correct FY Collection form must be completed annually.

38. To report the actual lease activity and executed lease amendments or extensions for the lease that the GAO will need to compile the ACFR, complete the GASB 87 LESSOR Activity Form every year that the lease is active.

39. Use the information and tables from the GASB 87 LESSOR Collection Form to complete the general lease information and Expected Lease Payments to be Received section (left-hand side) on the GASB 87 LESSOR Activity Form for the appropriate fiscal year.

40. Enter Actual Lease Payments Received (right-hand side) on the GASB 87 LESSOR Activity Form. All payments received from the lessee should be reflected to include differences in timing, amounts, other charges and variable charges. Provide any additional information needed to explain any variances or changes.

41. If applicable, complete the Lease Modifications section of the Activity Form. Note that the published applicable FY Discount Rates for the State of Arizona Leases may vary from fiscal year to fiscal year. Therefore, the correct fiscal year Activity Form must be completed annually.

42. *Lease Modifications-Lessor.*

43. There are certain changes that, if they occur, would require the lease receivable and deferred inflow of resources to be remeasured. These actions would cause the remeasurement only if the changes individually or in the aggregate are expected to significantly affect the amount of the lease receivable since the previous measurement. These actions include:

43.1. A change in the lease term (e.g., an extension or termination of the lease).

43.2. There is a change in the interest rate the lessor charges the lessee.

43.3. A contingency, upon which some or all of the variable payments that will be received over the remainder of the lease term are based, is resolved such that those payments now meet the criteria for measuring the lease receivable. For example, an event occurs that causes variable payments that were contingent on the performance or use of the underlying asset to become fixed payments for the remainder of the lease term.

43.4. If the lease had extensions or other amendments exercised, complete the Lease Modifications section of the GASB 87 LESSOR Activity Form. The GAO will use this section to determine what steps will be necessary for the correct reporting of the Lease in the ACFR.

44. Submit all three forms, the GASB 87 LESSOR Decision Form, GASB 87 LESSOR Collection Form for FYXXXX, and GASB 87 LESSOR Activity Form for FYXXXX to ACFR@azdoa.gov no later than the due date published for closing package submissions.

45. *Data Entry in AFIS.*

46. AFIS lease functionality is continuing to be developed for GASB 87 tracking and reporting but is not available at this time. There are currently no changes in the way lease payments are made in AFIS.