Posted: September 7, 2016

MEETING NOTICE AND AGENDA

COMMITTEE ON LOCAL GOVERNMENT FINANCE
SUBCOMMITTEE ON TYPES OF FINANCING GUIDANCE TO THE DEPARTMENT

Date and Time of Meeting: September 12, 2016 9:00 a.m.

Place of Meeting:
Department of Taxation
Large Conference Room
1550 College Parkway
Carson City, Nevada

Video Conference To:
Department of Taxation
1st Floor Conference Room
Grant Sawyer Office Building
555 East Washington Avenue
Las Vegas, Nevada

This meeting will also be part of a teleconference. Please call the Department at (775) 684-2100 for the teleconference number.
Action will be taken on the items indicated in **BOLD:**

1. ROLL CALL AND OPENING REMARKS

2. Public Comment (See Note 2)

3. **For Possible Action: Discussion and Consideration of Proposed Guidance Letter on the Treatment and Reporting Requirements connected with lease financing and installment purchase agreements**

4. **Discussion and Consideration of Recommendations for future regulatory oversight regarding new forms of financing**

5. BRIEFING TO AND FROM THE SUBCOMMITTEE ON LOCAL GOVERNMENT FINANCE AND LOCAL GOVERNMENT FINANCE STAFF
   a) Discussion of Matters Affecting Local Governments
   b) For Possible Action: Schedule Date and Review Agenda Topics for the Next Meeting

6. PUBLIC COMMENT (See Note 2)
   In consideration of others, who may also wish to provide public comment, please avoid repetition and limit your comments to no more than five (5) minutes.

7. **For Possible Action: ADJOURNMENT**

NOTE 1: Items on this agenda may be taken in a different order than listed. Items may be combined for consideration by the Committee on Local Government Finance. Items may be pulled or removed from the agenda at any time.
NOTE 2: In consideration of others, who may also wish to provide public comment, please avoid repetition and limit your comments to no more than five (5) minutes. Public comment may be made on any issue and any discussion of those items; provided that comment will be limited to areas relevant to and within the authority of the Committee on Local Government Finance. No action will be taken on any items raised in the public comment period. At the discretion of the Chairman, public comment may be received prior to action on individual agenda items. Public Comment may not be limited based on viewpoint. Prior to the commencement and conclusion of a contested case or a quasi-judicial proceeding that may affect the due process rights of an individual, the Committee may refuse to consider public comment. See NRS 233B.126.
NOTE 3: We are pleased to make accommodations for members of the public who are disabled. Please notify the Department of Taxation in writing, at 1550 College Parkway, Carson City Nevada, 89706 or call (775) 684-2180 prior to the meeting.
NOTE 4: Materials and files for items on this agenda are maintained in the offices of the Department of Taxation located in Carson City, Nevada. Requests for copies of materials and files for items on this agenda may be made to:
Terry Rubald, Deputy Executive Director, Department of Taxation 1550 College Parkway Carson City, NV 89701

Notice of this meeting was posted in the following Carson City, Nevada location: Department of Taxation 1550 College Parkway; Legislative Building, 401 South Carson Street; and Nevada State Library, 100 Stewart Street
Notice of this meeting was emailed for posting to the following locations: Department of Taxation, 4600 Kietzke Lane, Building L, Suite 235, Reno; Department of Taxation, 2550 Paseo Verde, Suite 180, Henderson; Department of Taxation, 555 E. Washington Street; Las Vegas; Clark County Office, 500 South Grand Central Parkway, Las Vegas. Notice of this meeting was also posted on the Internet through the Department of Taxation website at www.tax.nv.gov, on the Legislative website at www.leg.state.nv.us and on the Department of Administration website at https://notice.nv.gov/ .

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Guidance Letter 16-004

Date: September 12, 2016

To: County Finance Officers

From: Terry E. Rubald, Deputy Executive Director, Department of Taxation
Co-authored by Kelly Langley, Supervisor, Local Government Finance, Division of Local Government Services

CC: Committee on Local Government Finance, Marvin Leavitt, Chairman
Deonne Contine, Executive Director, Department of Taxation

Subject: Treatment and Reporting Requirements of Various Types of Leases

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SUMMARY

Local governments regularly enter into leases for various reasons. Leasing provides alternative financing solutions allowing government to have the benefit of necessary items such as vehicles, heavy equipment, and buildings without having to purchase them outright. Leasing may be the solution which allows local governments to preserve capital dollars for other projects for which leasing is not an option; enables improvement of cash flow; and incorporates flexible structuring to meet budget needs.

The purpose of this Guidance Letter is to clarify the types of installment purchase and medium-term obligation financing transactions subject to approval by the Department of Taxation pursuant to NRS 350.089. In addition, this Guidance Letter reviews the existing Governmental Accounting Standards Board ("GASB") standard on leases as well as the latest GASB exposure draft on lease accounting to assist the reader in understanding how to treat and report various financial lease arrangements pursuant to Nevada law. Finally, the Guidance Letter makes recommendations for reporting to the Department and on local government financial statements consistent with generally accepted accounting principles and Nevada law.

AUTHORITY FOR THIS LETTER

NRS 354.472(1)(d): One of the purposes of the Local Government Budget and Finance Act is to provide for the control of revenues, expenditures and expenses in order to promote prudence and efficiency in the expenditure of public money. NRS 354.612(2) requires fund financial statements and other schedules to be prepared in accordance with generally accepted accounting principles.

DISCUSSION

NRS 350.089 provides that medium-term obligations and installment-purchase agreements adopted by a local government must be approved by the Executive Director of the Department of Taxation ("Department"). A medium-term obligation is defined in NRS 350.007 as an obligation to repay borrowed money evidenced by a note or bond and having a term of 10 years or less, except for terms of less than 1 year which are payable in full from money appropriated for the same fiscal year that the obligation is incurred.

An installment-purchase agreement is specifically defined in NRS 350.0055 as the purchase of real or personal property by installment, lease, or other transaction types described in NRS 350.800 and which will be discussed in more detail below. Historically the Department has treated most capital leases as a type of installment purchase agreement subject to approval pursuant to NRS 350.089. Under NRS 350.089, however, installment-purchase agreements do not include obligations to pay rent pursuant to a lease which contains no option or right to purchase or which contain only an option or right to purchase the property without any credit towards the purchase price for lease or rental payments. With the advent of more creative leasing arrangements in recent times, it becomes important to understand the characteristics of leases in order to determine whether the lease is subject to Department approval.

The Department finds that Governmental Accounting Standards Board ("GASB") Statements, including but not limited to, No. 62, Codification of Accounting and Financial reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements and No. 34, Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments are appropriate standards for the preparation of financial statements for all funds and comply with the requirements of NRS 354.612(2) as generally accepted accounting principles. In particular, Statement No. 62 provides lease accounting standards for reporting leases in local government financial statements. Statement No. 34 establishes the components of basic financial statements for general purpose governments.

In addition, the Department recognizes GASB is in the process of adopting an Exposure Draft regarding financial reporting for leases by state and local governments. The GASB Exposure Draft coordinates with the Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ACU") on leases. The Department anticipates that when the updated GASB standard becomes effective on December 15, 2018, it will also comply with NRS 354.612(2).[1] The updated GASB standard will establish a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under both the updated GASB and FASB standards, a lessee will be required to recognize a lease liability and an intangible right-to-use lease asset. A lessor will be required to recognize a lease receivable and a deferred inflow of resources."[2] The goal of the revised ASU is to provide guidance in how to uniformly reflect actual lease liabilities in financial statements.

[1] Effective date is stated in the Exposure Draft, paragraph B129, page 49.

[2] GASB Exposure Draft, January 25, 2016 "Leases", pg iv. In addition, the 2016 GAAP Guide Volume II notes that the Financial Accounting Standards Board, ("FASB") has also released an Exposure Draft of an Accounting Standards Update ("ASU") on Leases that may have an important impact on the preparation of financial statements in the future. This proposed ASU is part of a joint project with the International Accounting Standards Board ("IASB") to develop a new approach to lease accounting that will ensure that assets and liabilities arising from lease agreements are reflected on an entity's statement of financial position. *See* Wolters Kluwer *2016 GAAP Guide Volume II* Restatement and Analysis of Current FASB. Standards, Chapter 54 ASC 840, pg. 54,053

Lease Accounting

Under GASB 62, a lease is defined as an agreement conveying the right to use capital assets (land and/or depreciable assets) but does not include agreements that are contracts for services that do not transfer the right to use capital assets from one contracting party to the other.[3]

GASB Statement No. 62 at paragraph 212 classifies leases into capital leases and operating leases from the standpoint of the lessee. From the standpoint of the lessor, leases may be classified as sales-type leases, direct financing leases, leveraged leases, or operating leases.

Criteria for Classifying Leases:

GASB 62, Paragraph 213 provides the criteria by which a lease may be classified as a capital or operating lease by the lessee. The criteria are summarized below.

Capital Leases

If at inception a lease meets *at least one* of the criteria outlined in paragraph 213 of GASB 62, the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease. Capital leases are essentially treated as a loan for book accounting purposes. The four criteria are:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option (i.e., less than the fair market value)
- The lease term is greater than 75% of estimated economic life of the equipment
- The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of leased property's fair market value.[4]

A capital lease is treated by the lessee as both the borrowing of funds and the acquisition of an asset to be depreciated; thus the lease is recorded on the lessee's balance sheet as an asset and corresponding liability (lease payable). Periodic lessee expenses consist of interest on the debt and depreciation of the asset.[5]

Operating Leases

Operating leases are all leases that cannot otherwise be classified as capital leases.[6] In general, an operating lease must have *all* of the following characteristics:

- The lease term is less than 75% of the estimated economic life of the equipment
- The present value of the lease payments is less than 90% of the leased property's fair market value
- The lease cannot contain a bargain purchase option (i.e., less than fair market value)

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[3] GASB Statement 62, Paragraph 211, p. 87.
[4] GASB 62, Paragraph 213 contains an exception to the minimum lease payment criterion. If the beginning of the lease term falls within the last 25% of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease. A lessor should compute the present value ("PV") of the minimum lease payment using the interest rate implicit in the lease. A lessee should compute the PV using its incremental borrowing rate, with additional caveats.
[5] GASB 62, Paragraph 216, p. 91; Paragraph 218, p. 92.
[6] GASB 62, Paragraph 212 (1)(2), p. 88

- Ownership is retained by the lessor during and after the lease term
- An operating lease is accounted for by the lessee without showing an asset (for the equipment) or a liability (for the lease payment obligations) on its balance sheet. Periodic payments are accounted for by the lessee as operating expenses for the period)

In addition, if none of the criteria for a capital lease are present and both the collectability of the minimum lease payments is reasonably predictable and no important uncertainties surround the amount of un-reimbursable costs yet to be incurred by the lessor under the lease, the lease is classified as an operating lease.

Paragraph 222 of GASB 62 notes that normally, rental on an operating lease should be charged to expense/expenditure over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense/expenditure nevertheless should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used.

Lease / Installment-purchase Agreements[7]:

An Installment-purchase Agreement is defined as an agreement for the purchase of real or personal property by installment, lease or other transaction in which a municipality acquires real or personal property and another person acquires or retains a security interest in that or other property. A security interest transaction must be counted against a municipality's debt limit, unless the obligation by its terms is extinguished by a failure of the governing body to appropriate money for the ensuing fiscal year for payment of the amounts then due (a "non-funding clause"); or the municipality's budget includes a provision for the discharge of the obligation in full in the same fiscal year as when the transaction occurs.[8]

Under NRS 350.089, an Installment-purchase Agreement also includes transactions not required to be counted against the municipality's debt limit if those transactions are (a) greater than $100,000 for local governments in a county whose population is 100,000 or more; or (b) greater than $50,000 for a local government in a county whose population is less than 100,000. However, if the Installment-purchase Agreement contains no option or right to purchase at the conclusion of the lease term; or if the lease contains an option or right to purchase the property but does not credit the lease payments towards the purchase price, then the lease is not considered an Installment-purchase Agreement for purposes of enforcement of NRS 350.089.

Application of GASB Standards

A local government which adopts a resolution authorizing a medium-term obligation or installment-purchase agreement whether or not subject to direct approval by the Department under NRS 350.089, however, is still obligated to prepare fund financial statements using generally accepted accounting principles pursuant to NRS 354.612(2). As stated above, GASB Statement No. 62, as well as the GASB and FASB Exposure Drafts soon to be finalized regarding the recognition and measurement of lease liabilities are viewed by the Department as generally accepted accounting principles. As such, local governments should recognize and

[7] Nevada Revised Statute (NRS) 350.0055
[8] NRS 350.800(1)(a-b)

measure lease liabilities pursuant to the model provided in the GASB and FASB Statements as of their effective dates.

The following discussion reviews GASB standards for lessees, however, the reader should be aware there are additional reporting requirements if the local government is the lessor.

For example, Paragraph 223 in GASB 62 requires disclosure of the following information with respect to leases in the notes to the lessee's financial statements:

a. For capital leases:
    1. The gross amount of assets recorded under capital leases as of the date of each set of financial statements presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.
    2. The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest financial statements presented.
    3. Total contingent rentals actually incurred for each period for which a cash flows statement is presented
    4. Assets recorded under capital leases and the accumulated amortization thereon. Unless the expense resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization expense should be disclosed in the notes to the financial statements.
b. For operating leases having initial or remaining non-cancelable lease terms in excess of one year, the total of minimum rentals to be received in the future under non-cancelable subleases as of the date of the latest financial statements presented.
c. For all operating leases, rental expense/expenditure for each period for which a cash flows statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals, Rental payments under leases with terms of a month or less that were not renewed need not be included.
d. A general description of the lessee's leasing arrangements including, but not limited to the following:
    (1) The basis on which contingent rental payments are determined
    (2) The existence and terms of renewal or purchase options and escalation clauses
    (3) Restrictions imposed by lease agreements, such as those concerning additional debt and further leasing

Under GASB 62, Paragraph 234, leases involving land and building(s) should be accounted for by the lessee by separately capitalizing each asset if the lease contains a provision to transfer ownership by the end of the term of the lease or if the lease contains a bargain purchase option. "For this purpose, the present value of the minimum lease payments after deducting executory costs, including any gain thereon, should be allocated between the two elements in proportion to their fair values at the inception of the lease." The reader should review GASB 62 for other standards if the lease involves land only, if the lease involves equipment as well as real estate, or if the lease involves only part of a building.

GASB 62, Paragraphs 244-256 also establish standards of accounting and financial reporting by a seller-lessee for sale-leaseback transactions involving real estate. For example, Paragraph 245 states that sale-leaseback accounting should be used by a seller-lessee only if a sale-leaseback transaction includes a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent; the payment terms and provisions adequately demonstrate the buyer-lessor's initial and continuing investment in the property; and the payment terms and provisions transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee. Paragraph 255 indicates that the notes to financial statements of a seller-lessee should include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

For the future, the GASB Exposure Draft concludes a lessee will recognize a lease liability and a lease asset at the beginning of a lease, and the lease liability will be measured at the present value of payments expected to be made for the lease term. 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 beginning of the lease and certain indirect costs.[9]

Paragraph 29 of the GASB Exposure Draft indicates that if a lease agreement is expected to be financed from general government resources, the lease should be accounted for and reported on a basis consistent with governmental fund accounting principles. Paragraph 31 indicates that a lessee's accounting for lease liability would include a description of leasing arrangements; the amount of lease assets recognized; the amount of lease assets by major classes of underlying assets, to be disclosed separately from other capital assets; and a schedule of future lease payments to be made in the notes to financial statements.

APPLICATION:

1. Until December 15, 2018, local governments should account for and report leases in the local government financial statements on a basis consistent with GASB 62. Thereafter, the local government may rely on the final adopted version of the Accounting Standards Update, which is currently known as the GASB Exposure Draft dated January 25, 2016. If the local government is considering early implementation of the new standard, implementation will require recognition and measurement of any previously unrecorded leases (i.e., operating leases) on the local government's financial statements.

2. NRS 350.013(1) requires local governments to submit a complete statement of current general obligation debt and special elective taxes, and a report of current debt and special assessments and retirement schedules, in the detail and form established by the Committee on Local Government Finance, known informally as the Indebtedness Report. Local governments may anticipate revised forms to accommodate the inclusion and listing of all leases recorded on the financial statements.

3. Lease accounting as provided in GASB 62 should only be applied to the lease elements of a contract; other elements of a contract should be treated according to the GASB standard appropriate to the contract element.

4. Local governments should review the terms of the agreement and determine whether the agreement is a medium-term obligation or installment-purchase or lease agreement subject to

[9] GASB Exposure Draft, 1-25-2016, p. iv

review and approval by the Department. If the agreement meets the definition in NRS 350.007 for a medium-term obligation or the definition in NRS 350.0055 for an installment-purchase agreement, prepare the documentation necessary for review and approval by the Department.

5. Guidelines and references with regard to the procedures for procuring medium-term obligations and installment-purchase agreements are available on the Department's website at http://tax.nv.gov/LocalGovt/PolicyPub/ArchiveFiles/Local_Government_Finance_Documents/

6. Evaluate the lease agreement to determine whether there is an option or right to purchase. For example, determine whether there is a bargain purchase option as that term is defined in GASB 62, Paragraph 271 at page 119. A bargain purchase option is a provision allowing the lessee the option to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured. If such a provision is present, and the terms of the agreement otherwise meet the definition of an installment-purchase agreement, the lease agreement is subject to review and approval by the Department.

7. Evaluate the lease agreement to determine whether the lease or rental payments are credited towards the purchase price. For example, consider a financing arrangement known as a "lease-leaseback project" in which property owned by a local government is leased to any person for a minimum amount, as long as such lease requires the other party to construct (or provide for the construction of) a building or buildings upon the subject property; and title to the subject property and the buildings vest in the local government at the expiration of the lease, either automatically or upon written notice or request by the local government.

The lease-leaseback approach is realized when a local government enters into two leases with a chosen design/build contractor or financing entity. One lease is a Site Lease and the other is a Facilities Lease. The Site Lease is the document in which the local government leases the real property to the builder or financing entity for a nominal amount (say, $1 per year). The Facilities Lease is the document the local government will utilize to lease back the real property and completed facilities. It is through the lease payments by the local government that the design/build contractor or financing entity will be paid. The vesting of title at the expiration of the Facilities Lease constitutes an option to purchase in which the lease payments are credited towards the purchase price for purposes of NRS 350.0055.

SELECTED REFERENCES

Nevada Revised Statutes, Chapters 350, 354, and 450:

NRS 350.0055 "Installment-purchase agreement" defined.

NRS 350.087 Resolution authorizing medium-term obligation or installment-purchase agreement: Adoption; contents; notice.

NRS 350.089 Approval of resolution for medium-term obligation or installment-purchase agreement by Executive Director of Department of Taxation; appeal to Nevada Tax Commission.

NRS 350.014 Approval or notification of commission required for certain proposals.

NRS 350.0145 Notice and submission of statement of certain proposals to commission; procedure for approval or disapproval.

NRS 354.472 Purposes of Local Government Budget and Finance Act.

NRS 450.665 Powers of board of trustees: Borrowing of money and incurrence or assumption of indebtedness; limitations and conditions.

NAC 350.120 Forwarding of documents to Department of Taxation following authorization.

NAC 350.130 Authorization void after 18 months.

Governmental Accounting Standards Board

Exposure Draft on Leases (January 25, 2016, Project No. 3-24E), as retrieved from the internet on September 8, 2016 at
http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804830991

Governmental Accounting Standards Board Statement No. 62, Codification of Accounting and Financial reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, as retrieved from the internet on September 8, 2016 at
http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176159967625

Governmental Accounting Standards Board Statement No. 34, Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments, as retrieved from the internet on September 8, 2016 at
http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160029121

Financial Accounting Standards Board

Financial Accounting Standards Board Statement 13, Accounting for Leases, as retrieved from the internet on September 8, 2016 at http://www.fasb.org/pdf/fas13.pdf

Exposure Draft on Leases (Topic 842) dated May 16, 2013, as retrieved from the internet on September 8, 2016 at
http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162613656

National Council on Governmental Accounting (NCGA)

Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*

If you have any questions about this guidance letter, please call the Local Government Finance Section of
the Division of Local Government Services, Department of Taxation at (775) 684-2100.

WEBSITE LOCATIONS:
Nevada Revised Statutes (NRS): http://www.leg.state.nv.us/NRS/
Nevada Administrative Code: http://www.leg.state.nv.us/NAC/CHAPTERS.html
Department of Taxation Guidance letters: http://www.tax.state.nv.us; then select "Publications;" then select Assessment
Standards Publications and "Guidance letters."

Statement No. 62 of the
Governmental Accounting
Standards Board

Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements

December 2010

Governmental Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

common stock,[84] and (3) the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.

b. For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price should be disclosed.

c. When investments in common stock accounted for under the equity method are, in the aggregate, significant in relation to the financial position or results of operations of a government, it may be necessary for summarized information about assets, liabilities, and results of operations of the investees to be presented in the notes to the financial statements either individually or in groups, as appropriate.

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances of an investee may have a significant effect on a government's share of reported earnings or losses. Accordingly, significant effects of possible conversions, exercises, or contingent issuances should be disclosed in notes to the financial statements of a government.

Leases

211. Paragraphs 211–271 establish standards of financial accounting and reporting for leases by lessees and lessors. For purposes of applying those paragraphs, a lease is defined as an agreement conveying the right to use capital assets (land and/or depreciable assets) usually for a stated period of time. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a "heat supply contract" for nuclear fuel.[85] This definition does not include agreements that are contracts for services that do not transfer the right to use capital assets from one contracting party to the other. On the other hand, agreements that do transfer the right to use capital assets meet the definition of a lease for purposes of applying paragraphs 211–271 even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance

[84]Disclosure should include (a) the names of any significant investee corporations in which the government holds 20 percent or more of the voting stock, but the common stock is not accounted for by the equity method, together with the reasons why the equity method is not considered appropriate and (b) the names of any significant investee corporations in which the government holds less than 20 percent of the voting stock and the common stock is accounted for by the equity method, together with the reasons why the equity method is considered appropriate.

[85]Heat supply (also called "burn-up") contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.

of such assets. Paragraphs 211–271 do not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor do those paragraphs apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.

Classification of Leases

212. For purposes of applying the accounting and financial reporting standards of paragraphs 211–271, leases are classified as follows:

a. Classifications from the standpoint of the lessee:
   (1) *Capital leases.* Leases that meet one or more of the criteria in paragraph 213.
   (2) *Operating leases.* All other leases.
b. Classifications from the standpoint of the lessor:
   (1) *Sales-type leases.* Leases that give rise to gain (or loss) (for example, the **fair value of the leased property**[86] at the **inception of the lease** is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph 213 and both of the criteria in paragraph 214, except as indicated in the following sentence. A lease involving real estate should be classified as a sales-type lease only if it meets the criterion in paragraph 213a, in which case the criteria in paragraph 214 do not apply. Leases involving lessors that primarily are engaged in financing operations will not normally be sales-type leases if they qualify under paragraphs 213 and 214 but most often will be direct financing leases, described in paragraph 212b(2), below. If a lessor leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales-type lease, assuming the criteria referred to are met. A renewal or extension[87] of an existing sales-type or direct financing lease that otherwise qualifies as a sales-type lease should be classified as a direct financing lease unless the renewal or extension occurs at or near the end of the original term[88] specified in the existing lease, in which case it should be classified as a sales-type lease. (See paragraph 224f.)
   (2) *Direct financing leases.* Leases other than leveraged leases that do not give rise to a gain (or loss) to the lessor but that meet one or more of the criteria in paragraph 213 and both of the criteria in paragraph 214. In such leases, the cost or carrying amount, if different, and fair value of the leased property are

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[86]Terms defined in the glossary (see paragraph 271) are shown in **boldface type** the first time they appear in paragraphs 212–271.

[87]As used here, *renewal* or *extension* includes a new lease under which the lessee continues to use the same property.

[88]A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term.

the same at the inception of the lease. An exception arises when an existing sales-type or direct financing lease is renewed or extended[89] during the term of the existing lease. In such cases, the fact that the carrying amount of the property at the end of the original **lease term** is different from its fair value at that date should not preclude the classification of the renewal or extension as a direct financing lease. (See paragraph 224f.)

(3) *Leveraged leases.* Leases that meet the criteria of paragraph 265.

(4) *Operating leases.* All other leases, including leases that involve real estate and give rise to a gain (or loss) to the lessor but do not meet the criterion in paragraph 213a.

Criteria for Classifying Leases (Other Than Leveraged Leases)

213. If at its inception a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee. Otherwise, it should be classified as an operating lease.

a. The lease transfers ownership of the property to the lessee by the end of the lease term.[90]

b. The lease contains a **bargain purchase option.**

c. The lease term is equal to 75 percent or more of the **estimated economic life of the leased property.** However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease.

d. The present value at the beginning of the lease term of the **minimum lease payments,** excluding that portion of the payments representing executory costs such as insurance and maintenance to be paid by the lessor, including any gain thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by and expected to be realized by the lessor. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion should not be used for purposes of classifying the lease. A lessor should compute the present value of the minimum lease payments using the **interest rate implicit in the lease.** A lessee should compute the present value of the minimum lease payments using its incremental borrowing rate, unless (1) it is practicable to obtain the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the **lessee's incremental borrowing rate.** If both of those conditions are met, the lessee should use the implicit rate.

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[89]See footnote 87.

[90]This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.

214. From the standpoint of the lessor, a lease involving real estate should be classified as a sales-type lease only if it meets the criterion in paragraph 213a as appropriate under paragraph 212b(1). Otherwise, if the lease at inception meets any one of the four criteria in paragraph 213 and in addition meets both of the following criteria, it should be classified as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease does not meet any of the criteria of paragraph 213 or both of the following criteria, the lease should be classified as an operating lease.

a. Collectibility of the minimum lease payments is reasonably predictable. A lessor should not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.
b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.[91] Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance and maintenance to be paid by the lessor (see paragraphs 224a and 226a) should not by itself constitute an important uncertainty as referred to herein.

215. If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 213 and 214 had the changed terms been in effect at the inception of the lease, the revised agreement should be considered a new agreement over its term, and the criteria in paragraphs 213 and 214 should be applied for purposes of classifying the new lease. Likewise, except when a guarantee or **penalty** is rendered inoperative as described in paragraphs 218 and 224e, any

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[91]If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criterion of paragraph 214b should be applied at the date that construction of the property is completed or the property is acquired by the lessor.

action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, should be considered a new agreement, which should be classified according to the provisions of paragraphs 212–214. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, should not give rise to a new classification of a lease for accounting purposes.

Accounting and Reporting by Lessees

Capital Leases

216. The lessee should record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance and maintenance to be paid by the lessor, together with any gain thereon. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation should be the fair value.[92] If the portion of the minimum lease payments representing executory costs, including gain thereon, is not determinable from the provisions of the lease, an estimate of the amount should be made. The discount rate to be used in determining present value of the minimum lease payments should be that prescribed for the lessee in paragraph 213d.

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[92]If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred should be considered in the determination of "fair value of the leased property at the inception of the lease" for purposes of applying this paragraph.

217. Except as provided in paragraphs 233 and 234 with respect to leases involving land, the asset recorded under a capital lease should be amortized as follows:

a. If the lease meets the criterion of either paragraph 213a or 213b, the asset should be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets.

b. If the lease does not meet either criterion 213a or 213b, the asset should be amortized in a manner consistent with the lessee's normal depreciation policy except that the period of amortization should be the lease term. The asset should be amortized to its expected value, if any, to the lessee at the end of the lease term. As an example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess which might be realized, the expected value of the leased property to the lessee is the amount that can be realized from it up to the amount of the guarantee.

218. During the lease term, each minimum lease payment should be allocated between a reduction of the obligation and interest expense/expenditure so as to produce a constant periodic rate of interest on the remaining balance of the obligation.[93] In leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term,[94] following the above method of amortization will result in a balance of the obligation at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term or a new lease under which the lessee continues to lease the same property renders the guarantee or penalty inoperative, the asset and the obligation under the lease should be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised agreement should be computed using the rate of interest used to record the lease initially.

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[93]This is the "interest" method described in paragraphs 185 and 186.

[94]Residual guarantees and termination penalties that serve to extend the lease term are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph.

In accordance with paragraph 215, other renewals and extensions of the lease term should be considered new agreements, which should be accounted for in accordance with the provisions of paragraph 219. **Contingent rentals** should be included in the flows statement[95] when accruable.

219. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a capital lease (see paragraph 221), a change in the provisions of a lease, a renewal or extension[96] of an existing lease, and a termination of a lease prior to the expiration of the lease term should be accounted for as follows:

a. If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (1) does not give rise to a new agreement under the provisions of paragraph 215 or (2) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation should be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement should be computed using the rate of interest used to record the lease initially. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the asset and obligation under the lease should be removed, a gain or loss should be recognized for the difference, and the new lease agreement should thereafter be accounted for as any other operating lease.
b. Except when a guarantee or penalty is rendered inoperative as described in paragraph 218, a renewal or an extension[97] of an existing lease should be accounted for as follows:
    (1) If the renewal or extension is classified as a capital lease, it should be accounted for as described in subparagraph (a) above.

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[95]For purposes of applying paragraphs 211–271, the term *flows statement* includes the government-wide statement of activities, the governmental fund statement of revenues, expenditures, and changes in fund balances, and the proprietary fund statement of revenues, expenses, and changes in fund net assets.

[96]See footnote 87.

[97]See footnote 87.

(2) If the renewal or extension is classified as an operating lease, the existing lease should continue to be accounted for as a capital lease to the end of its original term, and the renewal or extension should be accounted for as any other operating lease.

c. A termination of a capital lease should be accounted for by removing the asset and obligation, with a gain or loss recognized for the difference.

220. The termination of a capital lease that results from the purchase of a leased asset by the lessee is not the type of transaction contemplated by paragraph 219c but rather is an integral part of the purchase of the leased asset. The purchase by the lessee of property under a capital lease should be accounted for like a renewal or extension of a capital lease that, in turn, is classified as a capital lease. That is, any difference between the purchase price and the carrying amount of the lease obligation should be recorded as an adjustment of the carrying amount of the asset.

221. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a capital lease by the lessee, the change should be accounted for as follows:

a. If a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding that results in a defeasance of debt, the lessee should adjust the lease obligation to the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement and should defer the resulting gain or loss and amortize it as a component of interest expense/expenditure in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

b. If the provisions of a lease are changed in connection with an advance refunding by the lessor of tax-exempt debt that results in a defeasance of debt at the date of the advance refunding and the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred, such as unamortized discount or issue costs or a call premium, the lessee should accrue those costs by the "interest" method[98] over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Operating Leases

222. Normally, rental on an operating lease should be charged to expense/expenditure over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense/expenditure nevertheless should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis should be used.

Disclosures

223. The following information with respect to leases should be disclosed in the notes to the lessee's financial statements.

a. For capital leases:
   (1) The gross amount of assets recorded under capital leases as of the date of each set of financial statements presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.
   (2) The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest financial statements presented.
   (3) Total contingent rentals actually incurred for each period for which a flows statement is presented.
   (4) Assets recorded under capital leases and the accumulated amortization thereon. Unless the expense resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization expense should be disclosed in the notes to the financial statements.
b. For operating leases having initial or remaining noncancelable lease terms in excess of one year, the total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest financial statements presented.
c. For all operating leases, rental expense/expenditure for each period for which a flows statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

[98]See paragraph 218 and footnote 93 thereto.

d. A general description of the lessee's leasing arrangements including, but not limited to, the following:
   (1) The basis on which contingent rental payments are determined
   (2) The existence and terms of renewal or purchase options and escalation clauses
   (3) Restrictions imposed by lease agreements, such as those concerning additional debt and further leasing.

Accounting and Reporting by Lessors

Sales-Type Leases

224. Sales-type leases should be accounted for by the lessor as follows:

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as insurance and maintenance to be paid by the lessor, together with any gain thereon) plus the **unguaranteed residual value** accruing to the benefit of the lessor should be recorded as the gross investment in the lease. The **estimated residual value** used to compute the unguaranteed residual value accruing to the benefit of the lessor generally should not exceed the amount estimated at the inception of the lease.[99] However, if the sales-type lease involves real estate, the lessor should account for the transaction under the provisions of paragraphs 282–349 in the same manner as a seller of the same property.
b. The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment should be recorded as a liability. The discount rate to be used in determining the present values should be the interest rate implicit in the lease. The net investment in the lease should consist of the gross investment less the related liability. The liability should be recognized as revenue over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[100] The net investment in the lease should be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified statement of net assets. Contingent rentals should be included in the flows statement when accruable.
c. The present value of the minimum lease payments (net of executory costs, including any gain thereon), computed at the interest rate implicit in the lease, should be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any **initial direct costs,** less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, should be recognized in the same period.
d. The estimated residual value should be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination

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[99]If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred should be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of applying this paragraph.

[100]See footnote 93.

should be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction should be revised using the changed estimate. The resulting reduction in the net investment should be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value should not be made.

e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[101] following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension[102] of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value should be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment should be charged or credited to a liability.

f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (see paragraph 225), a change in the provisions of a lease, a renewal or extension[103] of an existing lease, and a termination of a lease prior to the expiration of the lease term should be accounted for as follows:

    (1) If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph 215 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, should be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment should be charged or credited to a liability. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment should be removed from the accounts, the leased asset should be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment should be charged to revenue in the period. The new lease should thereafter be accounted for as any other operating lease.

    (2) Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension[104] of an existing lease should be accounted for as follows:

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[101]See footnote 94.

[102]See footnote 87.

[103]See footnote 87.

[104]See footnote 87.

(a) If the renewal or extension is classified as a direct financing lease, it should be accounted for as described in subparagraph (f)(1) above.
(b) If the renewal or extension is classified as an operating lease, the existing lease should continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension should be accounted for as any other operating lease.
(c) If a renewal or extension that occurs at or near the end of the term[105] of the existing lease is classified as a sales-type lease, the renewal or extension should be accounted for as a sales-type lease.

(3) A termination of the lease should be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment should be charged to revenue in the period.

225. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, the change should be accounted for as follows:

a. If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that results in a defeasance of debt, the lessor should adjust the balance of the minimum lease payments receivable and the estimated residual value (that is, the gross investment in the lease), if affected in accordance with the requirements of paragraphs 226c and 224f(1). The adjustment of the liability should be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences should be recognized as a gain or loss over the remaining life of the old debt or the life of the new debt, whichever is shorter.
b. If a change in the provisions of a lease results from an advance refunding that results in a defeasance of debt, the lessor should systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Direct Financing Leases

226. Direct financing leases should be accounted for by the lessor as follows:

[105]See footnote 88.

a. The sum of (1) the minimum lease payments (net of amounts, if any, included therein with respect to executory costs, such as insurance and maintenance, to be paid by the lessor, together with any gain thereon) and (2) the unguaranteed residual value accruing to the benefit of the lessor should be recorded as the gross investment in the lease. The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor should not exceed the amount estimated at the inception of the lease.[106]

b. The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property should be recorded as a liability. The net investment in the lease should consist of the gross investment plus any unamortized initial direct costs less the related liability. The liability and initial direct costs should be amortized to revenue over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.[107] The net investment in the lease should be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified statement of net assets. Contingent rentals should be included in the determination of the change in net assets as accruable.

c. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,[108] the lessor should follow the accounting procedure described in paragraph 224e. The accounting provisions of paragraph 224f with respect to renewals and extensions not dealt with in paragraph 224e, terminations, and other changes in lease provisions also should be followed with respect to direct financing leases.

d. The estimated residual value should be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph 224d.

Operating Leases

227. Operating leases should be accounted for by the lessor as follows:

a. The leased property should be included with or near capital assets in the statement of net assets. The property should be depreciated following the lessor's normal depreciation policy, and in the statement of net assets, the accumulated depreciation should be deducted from the investment in the leased property.

b. Rent should be reported as revenue over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the revenue should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis should be used.

c. Initial direct costs should be deferred and allocated over the lease term in proportion to the recognition of rental revenue.

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[106]See footnote 99.

[107]See footnote 93.

[108]See footnote 94.

d. If, at the inception of the lease, the fair value of the property in an operating lease involving real estate that would have been classified as a sales-type lease except that it did not meet the criterion in paragraph 213a is less than its cost or carrying amount, if different, then a loss equal to that difference should be recognized at the inception of the lease.

Participation by Third Parties

228. The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease should not negate the original accounting treatment accorded the lease. Any gain or loss on the sale or assignment should be recognized at the time of the transaction except that (a) if the sale or assignment is between related parties, the provisions of paragraphs 239 and 240 should be applied or (b) if the sale or assignment is with recourse, it should be accounted for in accordance with Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.*

229. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, should not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property. A seller may by various arrangements assure recovery of the investment by the third-party purchaser in some operating lease transactions and thus retain substantial risks in connection with the property. For example, in the case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to (a) acquire the lease or the property, (b) substitute an existing lease, or (c) secure a replacement lessee or a buyer for the property under a remarketing agreement. However, a remarketing agreement by itself should not disqualify accounting for the transaction as a sale if the seller (i) will receive a reasonable fee

commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property and (ii) is not required to give priority to the re-leasing or disposition of the property owned by the third-party purchaser over similar property owned or produced by the seller. (For example, a FIFO remarketing arrangement is considered to be a priority.)

230. If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third-party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph 229 above, the transaction should be accounted for as a borrowing. (Transactions of these types are in effect collateralized borrowings.) The proceeds from the "sale" should be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases should be recorded as revenue by the seller, even if such rentals are paid directly to the third-party purchaser. A portion of each rental should be recorded by the seller as interest expense/expenditure, with the remainder to be recorded as a reduction of the obligation. The interest expense/expenditure should be calculated by application of a rate determined in accordance with the provisions of paragraphs 183 and 184. The leased property should be accounted for as prescribed in paragraph 227a for an operating lease, except that the term over which the asset is depreciated should be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease should be accounted for as a borrowing as described above.

Disclosures

231. When leasing, exclusive of leveraged leasing, is a significant part of the lessor's activities, the following information with respect to leases should be disclosed in the notes to financial statements:

a. For sales-type and direct financing leases:
   (1) The components of the net investment in sales-type and direct financing leases as of the date of each set of financial statements presented:
      (a) Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any gain thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable
      (b) The unguaranteed residual values accruing to the benefit of the lessor
      (c) For direct financing leases only, initial direct costs
      (d) Related liability (see paragraphs 224b and 226b).
   (2) Future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest financial statements presented.
   (3) Total contingent rentals included in the flows statement for each period presented.
b. For operating leases:
   (1) The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property, and the amount of accumulated depreciation in total as of the date of the latest financial statements presented.
   (2) Minimum future rentals on noncancelable leases as of the date of the latest financial statements presented, in the aggregate and for each of the five succeeding fiscal years.
   (3) Total contingent rentals included in the flows statement for each period presented.
c. A general description of the lessor's leasing arrangements.

Leases Involving Real Estate

232. For purposes of applying paragraphs 211–271, leases involving real estate can be divided into four categories: (a) leases involving land only, (b) leases involving land and building(s), (c) leases involving equipment as well as real estate, and (d) leases involving only part of a building.

Leases Involving Land Only

233. If land is the sole item of property leased and the criterion in either paragraph 213a or 213b is met, the lessee should account for the lease as a capital lease, otherwise, as an operating lease. If the lease gives rise to a gain (or loss) and the criterion of paragraph 213a is met, the lessor should classify the lease as a sales-type lease as appropriate under paragraph 212b(1) and account for the transaction under the provisions of paragraphs 282–349 in the same manner as a *seller* of the same property. If the lease does not give rise to a gain (or loss) and the criterion of paragraph 213a and both criteria of paragraph 214 are met, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b. If the criterion of paragraph 213b and both criteria of paragraph 214 are met, the lessor should account for the lease as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease does not meet the criteria of paragraph 214, the lessor should account for the lease as an operating lease. Criteria 213c and 213d are not applicable to land leases. Because ownership of the land is expected to pass to the lessee if either criterion 213a or 213b is met, the asset recorded under the capital lease normally would not be amortized.

Leases Involving Land and Building(s)

234. Leases involving both land and building(s) should be accounted for as follows:

a. The lease meets either criterion 213a or 213b:
   (1) Lessee's accounting: If either criterion (a) or (b) of paragraph 213 is met, the land and building should be separately capitalized by the lessee. For this purpose, the present value of the minimum lease payments after deducting executory costs, including any gain thereon, should be allocated between the two elements in proportion to their fair values at the inception of the lease.[109]

[109]See footnote 92.

The building should be amortized in accordance with the provisions of paragraph 217a. As stated in paragraph 233, land capitalized under a lease that meets criterion (a) or (b) of paragraph 213 would not normally be amortized.

(2) Lessor's accounting if the lease meets criterion 213a: If the lease gives rise to a gain (or loss), the lessor should classify the lease as a sales-type lease as appropriate under paragraph 212b(1) and account for the lease as a single unit under the provisions of paragraphs 282–349 in the same manner as a *seller* of the same property. If the lease does not give rise to a gain (or loss) and meets both criteria of paragraph 214, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b(2) or 212b(3). If the lease does not give rise to a gain (or loss) and does not meet both criteria of paragraph 214, the lessor should account for the lease as an operating lease.

(3) Lessor's accounting if the lease meets criterion 213b: If the lease gives rise to a gain (or loss), the lessor should classify the lease as an operating lease as appropriate under paragraph 212b(4). If the lease does not give rise to a gain (or loss) and meets both criteria of paragraph 214, the lessor should account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 212b(2) or 212b(3). If the lease does not give rise to a gain (or loss) and does not meet both criteria of paragraph 214, the lessor should account for the lease as an operating lease.

b. The lease meets neither criterion 213a nor 213b:

(1) If the fair value of the land is less than 25 percent of the total fair value of the leased property at the inception of the lease, both the lessee and the lessor should consider the land and the building as a single unit for purposes of applying the criteria of paragraphs 213c and 213d. For purposes of applying the criterion of paragraph 213c, the estimated economic life of the building should be considered the estimated economic life of the unit.

(a) Lessee's accounting: If either criterion (c) or (d) of paragraph 213 is met, the lessee should capitalize the land and building as a single unit and amortize it in accordance with the provisions of paragraph 217b; otherwise, the lease should be accounted for as an operating lease.

(b) Lessor's accounting: If either criterion (c) or (d) of paragraph 213 and both criteria of paragraph 214 are met, the lessor should account for the lease as a single unit, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. If the lease meets neither criterion (c) nor (d) of paragraph 213 or does not meet both criteria of paragraph 214, the lease should be accounted for as an operating lease.

(2) If the fair value of the land is 25 percent or more of the total fair value of the leased property at the inception of the lease, both the lessee and lessor should consider the land and the building separately for purposes of applying the criteria of paragraphs 213c and 213d. The minimum lease payments after deducting executory costs, including any gain thereon, applicable to the land and the building should be separated both by the lessee and the lessor by determining the fair value of the land and applying the lessee's incremental

borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments should be attributed to the building element.

(a) Lessee's accounting: If the building element of the lease meets criterion (c) or (d) of paragraph 213, the building element should be accounted for as a capital lease and amortized in accordance with the provisions of paragraph 217b. The land element of the lease should be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 213, both the building element and the land element should be accounted for as a single operating lease.

(b) Lessor's accounting: If the building element of the lease meets either criterion (c) or (d) of paragraph 213 and both criteria of paragraph 214, the building element should be accounted for as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 212b. The land element of the lease should be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 213 or does not meet the criteria of paragraph 214, both the building element and the land element should be accounted for as a single operating lease.

Leases Involving Equipment as Well as Real Estate

235. If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease should be estimated by whatever means are appropriate in the circumstances. The equipment should be considered separately for purposes of applying the criteria in paragraphs 213 and 214 and should be accounted for separately according to its classification by both lessees and lessors.

Leases Involving Only Part of a Building

236. When the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable, as for example, when an office or floor of

a building is leased.[110] If the cost and fair value of the leased property are objectively determinable, both the lessee and the lessor should classify and account for the lease according to the provisions of paragraph 234. Unless both the cost and the fair value are objectively determinable, the lease should be classified and accounted for as follows:

a. Lessee:
   (1) If the fair value of the leased property is objectively determinable, the lessee should classify and account for the lease according to the provisions of paragraph 234.
   (2) If the fair value of the leased property is not objectively determinable, the lessee should classify the lease according to the criterion of paragraph 213c only, using the estimated economic life of the building in which the leased premises are located. If that criterion is met, the leased property should be capitalized as a unit and amortized in accordance with the provisions of paragraph 217b.
b. Lessor: If either the cost or the fair value of the property is not objectively determinable, the lessor should account for the lease as an operating lease.

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying the lease is essentially indeterminate. Likewise, the concept of fair value is not applicable to such leases. Because such leases also do not provide for a transfer of ownership or a bargain purchase option, they should be classified as operating leases. Leases of other facilities owned by a governmental unit or authority wherein the rights of the parties are essentially the same as in a lease of airport facilities

[110]Information providing a basis for a reasonable estimate of fair value might be obtained through an appraisal or other similar valuation. That kind of information should be obtained whenever possible if (a) classification as a capital lease seems likely and (b) the effects of capital lease classification would be significant to the financial statements of a lessee. Also, a lessee's ability to make a reasonable estimate of the leased property's fair value will vary depending on the size of the leased property in relation to the entire facility. For example, obtaining a meaningful appraisal of an office or a floor of a multi-story building may not be possible whereas similar information may be readily obtainable if the leased property is a major part of that facility. For leases involving only part of a building, other evidence may provide a basis for an objective determination of fair value even if there are no sales of property similar to the leased property. For example, reasonable estimates of the leased property's fair value might be objectively determined by referring to an independent appraisal of the leased property or to estimated replacement cost information.

described above also should be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals.

237. The provisions of paragraph 236 stating that certain leases should be classified as operating leases are intended to apply to leases only if all of the following conditions are met:

a. The leased property is owned by a governmental unit or authority.
b. The leased property is part of a larger facility, such as an airport, operated by or on behalf of the lessor.
c. The leased property is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
d. The lessor, or in some cases a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the leased property to terminate the lease at any time during the lease term, such as by closing the facility containing the leased property or by taking possession of the facility.
e. The lease neither transfers ownership of the leased property to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the leased property.
f. The leased property or equivalent property in the same service area[111] cannot be purchased nor can such property be leased from a nongovernmental unit or authority.

238. Leases of property not meeting all of the conditions of paragraph 237 are subject to the same criteria for classifying leases under paragraphs 211–271 that are applicable to leases not involving government-owned property.

Leases between Related Parties

239. Except as noted below, leases between related parties should be classified in accordance with the criteria in paragraphs 213 and 214. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting should be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee

[111]As used here, *equivalent property in the same service area* is property that would allow continuation of essentially the same service or activity as afforded by the leased property without any appreciable difference in economic results to the lessee.

and lessor are related. In such cases, the classification and accounting should be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties should be disclosed.

240. In financial statements for which an interest in an investee is accounted for using the equity method, any gain or loss on a leasing transaction with the related party should be accounted for in accordance with the principles set forth in paragraphs 202–210.

Sale-Leaseback Transactions

241. Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life should be accounted for by the seller-lessee in accordance with the provisions of paragraph 242 and should be accounted for by the buyer-lessor in accordance with the provisions of paragraph 243.

242. If the lease meets one of the criteria for treatment as a capital lease (see paragraph 213), the seller-lessee should account for the lease as a capital lease; otherwise as an operating lease. Any gain or loss on the sale[112] should be deferred and amortized in proportion to the amortization of the leased asset,[113] if a capital lease, or in proportion to the related gross rental charged to expense/expenditure over the lease term, if an operating lease, unless:

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[112]*Gain or loss on the sale* is used in this paragraph to refer to the gain or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to paragraphs 282–349, the gain on the sale to be deferred and amortized in proportion to the leaseback would be the gain that could otherwise be recognized in accordance with those paragraphs.

[113]If the leased asset is land only, the amortization should be on a straight-line basis over the lease term.

a. The seller-lessee relinquishes the right to *substantially all* of the remaining use of the property sold (retaining only a *minor* portion of such use),[114] in which case the sale and the leaseback should be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount should be deferred or accrued, by adjusting the gain or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.
b. The seller-lessee retains more than a minor part but less than substantially all[115] of the use of the property through the leaseback and realizes a gain on the sale[116] in excess of (1) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (2) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the gain on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, should be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease should be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph 213d.
c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which case a loss should be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

243. If the lease meets the criteria in paragraphs 213 and 214, the buyer-lessor should record the transaction as a purchase and a direct financing lease; otherwise, the transaction should be recorded as a purchase and an operating lease.

Sale-Leaseback Transactions Involving Real Estate

244. Paragraphs 244–256 establish standards of accounting and financial reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as power plants and office buildings with furniture and fixtures. Under

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[114]*Substantially all* and *minor* are used here in the context of the concepts underlying the classification criteria of paragraphs 211–271. In that context, a test based on the 90 percent recovery criterion of those paragraphs could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

[115]*Substantially all* is used here in the context of the concepts underlying the classification criteria of paragraphs 211–271. In that context, if a leaseback of *the entire property sold* meets the criteria of those paragraphs for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold.

[116]See footnote 112.

those paragraphs, a sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Paragraphs 244–256 also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment[117] to a buyer-lessor and leases them back while retaining the underlying land.[118] In addition, paragraphs 244–256 apply to sale-leaseback transactions involving real estate with equipment that include separate sale and leaseback agreements (a) with the same entity or related parties and (b) that are consummated at or near the same time, suggesting that they were negotiated as a package. Except as specified in this paragraph, paragraphs 244–256 do not address sale-leaseback or other leasing transactions involving only equipment.

Criteria for Sale-Leaseback Accounting

245. Sale-leaseback accounting should be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph 246
b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs 289–297)
c. Payment terms and provisions that transfer *all* of the other risks and rewards of ownership as demonstrated by the absence of *any* other continuing involvement by the seller-lessee described in paragraphs 249–251, 306–319, and 321–323.

[117]The terms *property improvements* or *integral equipment* as used in paragraphs 244–256 refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building and a power plant.

[118]Paragraphs 318 and 319 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph 318 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. It is not the intent of paragraphs 244–256 to modify paragraph 318; thus, it does not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph 318. However, paragraphs 244–256 do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph 319.

246. A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee,[119] and excludes other continuing involvement provisions or conditions described in paragraphs 249–251. The phrase *active use of the property by the seller-lessee* refers to the use of the property during the lease term in the seller-lessee's operations, provided that subleasing of the leased back property is minor.[120] If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse operation or the operation of a golf course or a parking lot, for example, is considered active use.

Terms of the Sale-Leaseback Transaction

247. Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges should be considered in evaluating the continuing involvement provisions in paragraphs 249–251. Those terms or conditions include, but are not limited to, the sales price, the interest rate,

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[119]Paragraphs 244–256 distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph 250e.

[120]*Minor* is used in paragraphs 244–256 in the context of the definition in paragraph 242a and footnote 114.

and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation should be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property.

Continuing Involvement

248. A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback should be accounted for by the deposit method or as a financing, whichever is appropriate under paragraphs 282–349. The provisions or conditions described in paragraphs 249–251 are examples of continuing involvement for the purpose of applying paragraphs 244–256.

249. Paragraphs 306–319 and 321–323 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

a. The seller-lessee has an obligation or an option[121] to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.
b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time.

250. Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership should constitute continuing involvement for the purpose of applying paragraphs 244–256 to sale-leaseback transactions and include, but are not limited to, the following:

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[121] A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase.

a. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.
b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.
c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.
d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.
e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.[122]

251. The following provisions or conditions also should be considered examples of continuing involvement for the purpose of applying paragraphs 244–256 to sale-leaseback transactions:

a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment[123] without leasing the underlying land to the buyer-lessor.[124]
b. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.
c. Any other provision or circumstance that allows the seller-lessee to participate in any future gains of the buyer-lessor or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor.

Sale-Leaseback Transactions by Regulated Enterprises

252. The provisions of paragraphs 252–254 apply to sale-leaseback transactions of a regulated enterprise subject to paragraphs 476–500. That accounting may result in a difference between the timing of revenue and expense recognition required by paragraphs 244–256 and the timing of revenue and expense recognition for rate-making purposes.

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[122]See footnote 119.

[123]See footnote 117.

[124]See footnote 118.

The timing of revenue and expense recognition related to the sale-leaseback transaction should be modified as necessary to conform to paragraphs 476–500. That modification required for a transaction that is accounted for by the deposit method or as a financing is further described in paragraphs 253 and 254.

253. If a sale-leaseback transaction is accounted for by the deposit method but the sale is recognized for rate-making purposes, the amortization of the asset should be modified to equal the total of the rental expense and the gain or loss allowable for rate-making purposes. Similarly, if the sale-leaseback transaction is accounted for as a financing and the sale is recognized for rate-making purposes, the total of interest imputed under the interest method for the financing and the amortization of the asset should be modified to equal the total rental expense and the gain or loss allowable for rate-making purposes.

254. The difference between the amount of revenue or expense recognized for a transaction that is accounted for by the deposit method or as a financing under paragraphs 244–256 and the amount of revenue or expense included in allowable cost for rate-making purposes should be capitalized or accrued as a separate regulatory-created asset or liability, as appropriate, if that difference meets the criteria of paragraphs 476–500.

Financial Statement Presentation and Disclosure

255. In addition to the disclosure requirements in paragraphs 223, 231, 239, and 270, the notes to financial statements of a seller-lessee should include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

256. The notes to financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the provisions of paragraphs 244–254 also should disclose the total minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding fiscal years.

Accounting and Reporting for Subleases and Similar Transactions

257. Paragraphs 257–263 deal with the following types of leasing transactions:

a. The leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect (a sublease).
b. A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under the agreement, and the original lessee may or may not be secondarily liable.
c. A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

Accounting by the Original Lessor

258. If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor should continue to account for the lease as before.

259. If the original lease agreement is replaced by a new agreement with a new lessee, the lessor should account for the termination of the original lease as provided in paragraph 224f and should classify and account for the new lease as a separate transaction.

Accounting by the Original Lessee

260. If the nature of the transaction is such that the original lessee is relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraphs 257b and 257c, the termination of the original lease agreement should be accounted for as follows:

a. If the original lease was a capital lease, the asset and obligation representing the original lease should be removed from the accounts, a gain or loss should be recognized for the difference, and, if the original lessee is secondarily liable, the loss contingency should be treated as provided by paragraphs 96–113. Any consideration paid or received upon termination should be included in the determination of the gain or loss to be recognized.
b. If the original lease was an operating lease and the original lessee is secondarily liable, the loss contingency should be treated as provided by paragraphs 96–113.

261. If the nature of the transaction is such that the original lessee is not relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraph 257a, the original lessee, as sublessor, should account for the transaction as follows:

a. If the original lease met either criterion (a) or (b) of paragraph 213, the original lessee should classify the new lease in accordance with the criteria of paragraphs 213 and 214. If the new lease meets one of the criteria of paragraph 213 and both of the criteria of paragraph 214, it should be accounted for as a sales-type or direct financing lease, as appropriate, and the unamortized balance of the asset under the original lease should be treated as the cost of the leased property. If the new lease does not qualify as a sales-type or direct financing lease, it should be accounted for as an operating lease. In either case, the original lessee should continue to account for the obligation related to the original lease as before.
b. If the original lease met either criterion (c) or (d) but not criterion (a) or (b) of paragraph 213, the original lessee should, with one exception, classify the new lease in accordance with the criteria of paragraphs 213c and 214 only. If it meets those criteria, it should be accounted for as a direct financing lease, with the unamortized balance of the asset under the original lease treated as the cost of the leased property; otherwise, as an operating lease. In either case, the original lessee should continue to account for the obligation related to the original lease as before. The one exception arises when the timing and other circumstances surrounding the sublease are such as to suggest that the sublease was intended as an integral part of an overall transaction in which the original lessee serves only as an intermediary. In that case, the sublease should be classified according to the criteria of paragraphs 213c and 213d, as well as the criteria of paragraph 214. In applying the criterion of paragraph 213d, the fair value of the leased property should be the fair value to the original lessor at the inception of the original lease.
c. If the original lease is an operating lease, the original lessee should account for both it and the new lease as operating leases.

262. Paragraph 261 does not prohibit the recognition of a loss by an original lessee who disposes of leased property or mitigates the cost of an existing lease commitment by subleasing the property.

Accounting by the New Lessee

263. The new lessee should classify the lease in accordance with the criteria of paragraph 213 and account for it accordingly.

Accounting and Reporting for Leveraged Leases

264. From the standpoint of the lessee, leveraged leases should be classified and accounted for in the same manner as nonleveraged leases. Paragraphs 264–270 deal with leveraged leases from the standpoint of the lessor.

265. For purposes of applying paragraphs 211–271, a leveraged lease is defined as one having all of the following characteristics:

a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph 212b(2), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph 212b(1) should not be accounted for as leveraged leases but should be accounted for as prescribed in paragraph 224.
b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.
d. The lessor's net investment, as defined in paragraph 266, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition should be accounted for by the lessor using the method described in paragraphs 266–270. A lease not meeting the definition of a leveraged lease should be accounted for in accordance with its classification under paragraph 212b.

266. The lessor should record an investment in a leveraged lease net of the nonrecourse debt. The net of the balances of the following accounts should represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt
b. The estimated residual value of the leased asset. The estimated residual value generally should not exceed the amount estimated at the inception of the lease.[125]

267. Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years[126] in which it is positive should be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the revenue to those years and is distinct from the interest rate implicit in the lease. In each year, whether positive or not, the difference between the net cash flow and the amount of revenue recognized, if any, should serve to increase or reduce the net investment balance.

268. If the projected net cash receipts[127] over the term of the lease are less than the lessor's initial investment, the deficiency should be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs 266 and 267 would result in a loss being allocated to future

[125]See footnote 99.

[126]The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

[127]For purposes of applying this paragraph, net cash receipts should be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment.

years, that loss should be recognized immediately. This situation might arise in cases in which one of the important assumptions affecting revenue is revised (see paragraph 269).

269. Any estimated residual value and all other important assumptions affecting estimated total revenue from the lease should be reviewed at least annually. If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total revenue from the lease, the rate of return and the allocation of revenue to positive investment years should be recalculated from the inception of the lease following the method described in paragraph 267 and using the revised assumption. The accounts constituting the net investment balance should be adjusted to conform to the recalculated balances, and the change in the net investment should be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value should not be made.

Disclosures

270. When leveraged leasing is a significant part of the lessor's operations, the components of the net investment balance in leveraged leases as set forth in paragraph 266 should be disclosed in the notes to the financial statements.

Glossary

271. This paragraph contains definitions of certain terms *as they are used in paragraphs 212–271;* the terms may have different meanings in other contexts.

Bargain Purchase Option

A provision allowing the lessee the option to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Bargain Renewal Option

A provision allowing the lessee the option to renew the lease for a rental sufficiently lower than the fair rental[128] of the property at the date the option becomes exercisable such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

Contingent Rentals

The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or pre-construction period should be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, should be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of revenue or expense/expenditure as accruable.

[128] *Fair rental* in this context means the expected rental for equivalent property under similar terms and conditions.

Estimated Economic Life of Leased Property

The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

Estimated Residual Value of Leased Property

The estimated fair value of the leased property at the end of the lease term.

Fair Value of the Leased Property

The price for which the property could be sold in an arm's-length transaction between willing parties, that is, other than in a forced or liquidation sale. The following are examples of the determination of fair value:

a. The fair value of the property at the inception of the lease, in some cases, will be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value should be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.
b. The fair value of the property at the inception of the lease, in some cases, will be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value should be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different. (See paragraph 212b.)

Inception of the Lease

The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment should be in writing, signed by the parties in interest to the transaction, and should specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

Initial Direct Costs[129]

Only those costs incurred by the lessor that are (1) costs to originate a lease incurred in transactions with independent third parties that (a) result directly from and are essential to acquire that lease and (b) would not have been incurred had that leasing transaction not occurred and (2) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities should include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs should not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs should not include administrative costs, rent, depreciation, any other occupancy and equipment costs and employees' compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.

Interest Rate Implicit in the Lease

The discount rate that, when applied to (1) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together

[129]Initial direct costs should be offset by nonrefundable fees that are yield adjustments as prescribed in paragraphs 431–451.

with any gain thereon, and (2) the unguaranteed residual value accruing to the benefit of the lessor,[130] causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by and expected to be realized by the lessor. (This definition does not necessarily include all factors that a lessor might recognize in determining the lessor's rate of return. For an example, see paragraph 267.)

Lease Term

The fixed noncancelable[131] term of the lease plus (1) all periods, if any, covered by **bargain renewal options,** (2) all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (3) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property[132] is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (4) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and (5) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case should the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A

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[130]If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to the lessor's benefit.

[131]See paragraphs 18–21 of NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments,* regarding fiscal funding and cancellation clauses.

[132]The phrase *indirectly related to the leased property* is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessor's debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessor's debt on behalf of the lessee, or the lessee financing the lessor's purchase of the leased asset using collateral other than the leased property.

lease that is cancelable (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured should be considered "noncancelable" for purposes of this definition.

Lessee's Incremental Borrowing Rate

The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the resources necessary to purchase the leased asset.

Minimum Lease Payments

a. From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property.[133] However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance and maintenance in connection with the leased property should be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option should be included in the minimum lease payments. Otherwise, minimum lease payments include the following:
   (1) The minimum rental payments called for by the lease over the lease term.
   (2) Any guarantee by the lessee[134] of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property.[135] When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount should be considered a lessee guarantee. When the lessee

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[133]Contingent rentals as defined in this glossary should be excluded from minimum lease payments. Contingent rentals should be recognized as period costs when incurred (or revenue when receivable). (See paragraphs 218, 224b, and 226b.)

[134]A guarantee by a third party related to the lessee should be considered a lessee guarantee.

[135]A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor should not be used to reduce the amount of the lessee's minimum lease payments under paragraphs 211–271 except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and should not be included in the lessee's minimum lease payments.

agrees to make up any deficiency[136] below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments should be the stated amount,[137] rather than an estimate of the deficiency to be made up.

(3) Any payment that the lessee is required to make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. In this connection, it should be noted that the definition of lease term includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured." If the lease term has been extended because of that provision, the related penalty should not be included in minimum lease payments.

b. From the standpoint of the lessor: The payments described in (a) above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee[138] or the lessor,[139] provided the third party is financially capable of discharging the obligations that may arise from the guarantee.

Penalty

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness

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[136]A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value for purposes of applying paragraphs 211–271.

[137] If a lease limits the amount of the lessee's obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessee's guarantee to be included in minimum lease payments under paragraphs 211–271 should be limited to the specified maximum deficiency the lessee can be required to make up. In other words, the "stated amount" referred to in paragraphs 211–271 is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessor's risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor should look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the lease property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it. The 90 percent test specified in criterion (d) of paragraph 213 is stated as a lower limit rather than as a guideline.

[138]See footnote 134.

[139]If the guarantor is related to the lessor, the residual value should be considered unguaranteed.

of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's operations or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

Unguaranteed Residual Value

The estimated residual value of the leased property exclusive of any portion guaranteed by the lessee[140] or by a third party unrelated to the lessor.[141]

Nonmonetary Transactions

272. Some transactions involve an **exchange**[142] with another entity (reciprocal transfer) that involves principally **nonmonetary assets or liabilities.** Exchanges that involve little or no **monetary assets or liabilities** are referred to in paragraphs 272–281 as nonmonetary transactions.

273. Paragraphs 272–281 do not apply to the following transactions:

a. A government combination
b. A transfer of nonmonetary assets solely between reporting units within the same reporting entity, such as between a primary government and its component units or between two component units of the same reporting entity, or between a joint venture and its owners or participating governments[143]
c. Nonexchange transactions.

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[140]See footnote 134.

[141]See footnote 139.

[142]Terms defined in the glossary (see paragraph 281) are shown in **boldface type** the first time they appear in paragraphs 272–280.

[143]The accounting and reporting standards for intra-entity transactions are provided in Statement 48.

Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as "boot," even though the exchange is essentially nonmonetary. Paragraphs 272–281 also apply to those transactions. For purposes of applying those paragraphs, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets are monetary transactions because the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

Basic Principle

274. In general, accounting for nonmonetary transactions should be based on the fair values[144] of the assets (or services) involved, which is the same basis as that used in monetary transactions. Therefore, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.

Modifications of the Basic Principle

Fair Value Not Determinable

275. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph 278).

[144] See paragraph 278 for determination of fair value.

Exchanges

276. If the exchange is not essentially the culmination of an earning process, accounting for an exchange of a nonmonetary asset between a government and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished. The following two types of nonmonetary exchange transactions do not culminate in an earning process:

a. An exchange of a product or property held for sale in the ordinary course of operations for a product or property to be sold in the same function to facilitate sales to customers other than the parties to the exchange, and
b. An exchange of a **productive asset** not held for sale in the ordinary course of operations for a **similar productive asset** or an equivalent interest in the same or similar productive asset.

277. The exchanges of nonmonetary assets that otherwise would be based on recorded amounts (paragraph 276) may include an amount of monetary consideration. The recipient of the monetary consideration has realized a gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The government paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 276 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 276, the entire indicated loss on the exchange should be recognized.

Minutes of the Subcommittee Meeting
COMMITTEE ON LOCAL GOVERNMENT FINANCE
TYPES OF FINANCING GUIDANCE TO THE DEPARTMENT
August 1, 2016
9:30 a.m.

The meeting was held at the Department of Taxation, 1550 College Parkway, Carson City, Nevada and video-conferenced to the Grant Sawyer State Office Building, 555 E. Washington Avenue, Room 4401, Las Vegas, Nevada.

COMMITTEE MEMBERS PRESENT:

Marty Johnson, Chairman
Marvin Leavitt
Jeff Zander

COMMITTEE MEMBERS ABSENT:

Jessica Colvin

COUNSEL TO COMMITTEE

Peter Keegan

DEPT OF TAXATION STAFF PRESENT:

Terry Rubald
Kelly Langley
Keri Gransberry
Penny Hampton
Chali Spurlock

MEMBERS OF THE PUBLIC PRESENT:

Name	**Representing**
Anna Thornley	NV Taxpayers Association
Jeff Zander	Elko County
Wes Henderson	League of Cities & Municipalities
Alan Kalt	Churchill County
Brett Hilton	UMC
Brent Loveland	UMC

ITEM 1. ROLL CALL AND OPENING REMARKS

Chairman Johnson called the meeting to order at 9:30 a.m. Roll call was taken and it was determined that a quorum was present.

Chairman Johnson opened with clarification that he is not an employee of any local government; the business he is in, is to help local governments do financing. His understanding is that what they are trying to accomplish is to provide guidance. He does not see it requiring businesses to hire professional services with financing. He does not see that this would impact his business or anyone else's.

ITEM 2. PUBLIC COMMENT

There was no public comment.

ITEM 3. For Possible Action: Discussion and Consideration of Proposed Guidance to the Department of Taxation regarding various types of financing including medium term obligations, installment purchase agreements, and other forms of financing such as, but not limited to, "lease-leaseback" structures.

Chairman Johnson made an introductory comment that what brought us to the point of having a subcommittee was the financing done by the Elko Convention and Visitors Authority. That financing caused us to decide that we need to look at guidance on what kind of financing should be authorized. His intention would be to provide a list of do's and don'ts in a guidance letter that could be sent out to local governments.

Marvin Leavitt agreed with Chairman Johnson. He stated we need further understanding. His position is that we do need to provide guidance, the dos and don'ts, and how it relates to the various financing.

Terry Rubald, with the Department of Taxation, requested to go over the exhibits, and what questions the Department has. She referred to their packets, chapter 350 which provides the process local government has to go through in order to get a medium term obligation approved, basically; the local government has to adopt a resolution or an installment purchase agreement. Then the Department goes through a process of review looking for probable ability of the local government to repay the obligation or installment purchase agreement. They also look for the compliance of the local government with all the applicable provisions of law. If the Department does not approve it, it can be appealed to the Nevada Tax Commission.

Ms. Rubald then referred to the checklist example in the exhibits. She explained the Department uses this checklist for a medium term obligation or an installment purchase agreement. They make sure the public has been properly noticed about the financing and that the resolution contains all the requirements provided in NRS Chapter 350. That includes a finding by the governing body that the public interest requires the medium term financing, a statement specifying the fund sources for repayment, and that there is an indication that there was board discussion and approval via the minutes of the meeting.

Ms. Rubald continued on the 2nd page of the checklist, where they ask for a statement for intended time for procuring the medium term financing, a proposed amortization schedule for repayment of the proposed obligation, and in the case of local governments that are formed under NRS Chapter 318, whether the financing was approved by the debt management commission. If the proposed obligation is for an installment purchase agreement of more than 10 years, the written approval of the debt management commission is requested, and an analysis comparing the cost of installment purchase financing with other available methods of financing. They also look at the highest overlapping tax rate is for the entity, and whether the entity is in compliance with the various filing requirements of Chapter 354. They look at the fund identified to service the proposed debt, whether the revenue sources to that fund are reasonable and consistent, whether the entity identified a particular revenue source to fund the repayment, whether there are other outstanding debt issues serviced by this fund, whether future balloon payments will affect the expenditure pattern of the fund or the future service of the proposed issue, whether the entity maintains a debt service fund, the nature and duration of the debt, and whether there is available room in the debt margin of the entity.

Ms. Rubald went on to page 3 of the checklist. The Department looks at actual and budgeted ending fund balances. They review the overall financial health of the entity, the schedule of long term debt, the debt management policy, and their capital improvement plan.

Ms. Rubald stated that all of this is designed to ensure the local government can afford the medium term obligation or installment purchase agreement and to make sure the financing was transparent to the public. She mentioned that last June at their CLGF meeting, they brought forward an example of a different form of financing called lease-leaseback structure. Part of that structure is in the packet, part has been redacted as this is only an example of the types of financing potentially avail to local governments. The lease-leaseback structure is designed to provide leased facilities to the local government without incurring a debt obligation to the government. The facilities are privately financed, constructed and owned. The local government leases back the facility from the 3rd party. This form of financing has some aspects of a capital lease or long term lease, but not all of them. The part that is not in the packet, but was reviewed last June at the meeting, is the facility use agreement where the local government allowed the 3rd party to lease the land on which it builds the building, and the 3rd party leases it back to the local government. In this example there is a 25 year obligation for rents. In addition, the local government pays a substantial base use fee, and other fees, which in this example amounted to several million dollars. The 3rd party has borrowed the money, but the terms of the borrowing provide for a balloon payment in 10 years. In the event the 3rd party's loan can't be refinanced on terms acceptable to the local government, then the local government will be in default of the lease agreement. Otherwise, the base use fee is adjusted and the local government pays the balloon payment and/or agrees to the refinancing. In the example provided, there has been some confusion as this lease-leaseback structure was reported as a capital lease in the CAFR but there was no request to approve an installment purchase agreement to the Department, because the local government later said it was an operating lease that did not need department oversight. This example has been described as nonrecourse financing, by going through a 3rd party that gets the financing and owns the facility, there is no requirement to use prevailing wage laws, it cuts financing red tape, and the local government apparently doesn't have to go through loan counsel. This example has brought up a number of questions to the Department.

Ms. Rubald clarified that the prepayments in the form of base fees were significant and they wonder if those types of base fees should be noted in the CAFR, and should this form of financing be on the indebtedness reports because of the magnitude of the operating lease. How should the lease payments be shown? Should it be an operating lease in service and supplies, or should it be shown as a capital lease? Should it be considered an installment purchase agreement for purposes of oversight, or should it be subject to the approval of the local debt management commission? Basically, the Department is asking if this is debt or not for purposes of the indebtedness report and/or the medium term obligation installment purchase review.

Ms. Rubald asked if Kelly Langley would like to add anything else.

Kelly Langley, with the Department of Taxation, stated Ms. Rubald had summarized it very well. She stated their concern was that the large payment, the prepayment, was issued with tax dollars from an account that, at the time, had received ad valorem and the representative prepayment for the following 25 years so that their future payments could be produced.

Ms. Rubald stated to Chairman Johnson that the Department doesn't know what to do with it.

Chairman Johnson stated he understands what they are saying. He commented that he thinks there are some misunderstandings of what debt is. In some cases debt is a general obligation, in other cases, like in installment purchase agreements, it's not a debt, but there is still an obligation to make an annual payment. He thinks one thing they need to make sure that they do in this guidance, is to make sure there is a clear understanding. Just because something is not considered a debt, like capital deeds, doesn't necessarily mean that it doesn't need to be authorized. There is also the concept of the pledge of revenue. The ability to use revenue to make a debt service and the pledging of that revenue are two different things. He gave an example that we can pledge gas tax, sales tax, and a variety of other revenues, but there are some revenues you can't pledge. He thinks that it confuses folks as well.

Chairman Johnson mentioned the checklist, and asked Ms. Rubald what local governments have that tell them what they need to do if they go into medium term financing. He asked if this checklist was available to them.

Ms. Rubald stated this is for internal use only. Ms. Rubald asked Penny Hampton, with the Department of Taxation, if local governments have a checklist of their own. Wes Henderson, with Nevada League of Cities and Municipalities, stated there is a packet online. Ms. Hampton clarified they have a packet, but not a checklist.

Chairman Johnson stated after doing this for 25 years, he has not looked at the checklist in a very long time. He said years ago they had a discussion about a tax rate election question, to put a tax rate outside of the GAAP. He wonders if this applies here, that all they can do is make the information available, that if the local governments don't use it, or follow it, what kind of recourse there is.

Ms. Rubald noted the only recourse is regulation or statute. The documents on the website are a reflection of what the statute asks for.

Ms. Hampton stated we are talking about ECVA's and they have elected to structure it as an operating lease, and it has taken the whole transaction outside of what we normally review.

Ms. Rubald replied that we would probably require a statutory change to include operating leases of that magnitude. Then we need to decide what magnitude that is, is it the number of years or the base fees amounting to millions. There are a lot of operating leases we don't care about.

Ms. Hampton stated typically those are simply expenses and included in part of their services and supplies.

Ms. Rubald asked if we want to distinguish between the size, or the magnitude of the operating lease or not because it might have an effect on the overall health of the organization.

Chair Johnson asked if the concern on this one is the payments and the term of the payments between the entity and the contractor, or the fact that there was financing done against it, or is it the whole thing.

Ms. Langley stated she thinks it's the size of the payments over the term (25 years), as well as the fact that they stated they could walk away at the end of that time. The goal is that they own that at the end of the term. Also, the way in which it was financed brings concerns over if whether the board understands the terms of the financing. The auditors and the accountants did not understand it. They showed it as a capital lease and were going to depreciate it. It only came to their attention when the entity decided to ask questions as to how it works on their indebtedness reports.

Ms. Rubald clarified that an operating lease does not go on the books. It doesn't become a part of the assets.

Ms. Langley stated the entity originally thought it was a capital lease, at least the auditor. When the department asked questions, they then said no, it wasn't a capital lease. The statements made conflicted their CAFR. The CAFR completely misrepresented that transaction.

Ms. Rubald suggested they need to engage in identification on when a transaction is an operating lease, and when it is a capital lease. She explained her concern is transparency. This is a relatively big undertaking, a large facility in this example that the public thinks is theirs, but it's not. They paid a lot, millions of dollars, for a base fee, and continue to pay large amounts for the operating lease. There is no mechanism to afford transparency to the public.

Ms. Langley asked if GAAP has any regulation because of the size. The annual payment is approximately half a million dollars. She asked if there was something because of size that accounting regulations would require it to be treated differently.

Chairman Johnson stated he is not a CPA and does not know about the accounting regulations.

Mr. Leavitt commented that normally in operating leases it's something that is not resolved in the acquisition of major plant equipment. We would not see large buildings, large structures or sewer plants, things like that normally structured with an operating lease. He would think if a lease was to be involved, it would be a capital lease, or a debt would be incurred, or medium term obligation, revenue bond, general obligation bond, or something of that nature. It appears now we are talking about acquiring major facilities, but it's structured in such a way that it becomes an operating lease which is foreign to what we have done in the past. He gave an example that you do one of these to build a city hall. If you don't make payments, you could be turned out of your city hall building, which is a major disruption to government. It's an essential facility. He asked if you could build an essential facility, which in a way is necessary to the government, and incur an obligation with multiple payments to build it, even though the form of it is different than what we normally consider debt. What process should we go through to get it approved, is it enough that the governing board approves it, should it be similar to the medium term financing where the Department of Taxation has a role in that? His concern is he suspects we will see a bunch of these, and it could be a concern. We also need to address if one of these is trying to be incurred by a local government on financial difficulty watch.

Ms. Rubald wondered if this particular example is most like an installment purchase agreement, as they expect to own it at the end of the term, even though they are not obligated during the term, they can back away at any time. Chapter 354 has a definition of installment purchase agreement; it says the term installment purchase agreement does not include an obligation to pay rent pursuant to a lease which contains no option or right to purchase, or which contains only an option or right to purchase the property without any credit towards the purchase price. She stated she is beginning to wonder if they will have to have a statutory change to address this kind of financing.

Jeff Zander stated he is sort of familiar with this, being from Elko, especially when they were building this building. The legislative session was in place and the governor had passed regulation to exempt school districts from prevailing wage. They awarded a bid while that regulation was in place, so they were one of the few school districts in the state that benefited from that. In the meantime contractor boards picketed their office, while the convention center was down the road being built and not paying prevailing wages on that facility. He thinks it saved the taxpayers some money, and that's a good thing. He said the issue is whether this is a capital lease or an operating lease. The fact that you do an operating lease and build a facility on convention center land clouds that issue. It doesn't make any sense to him that the government would pay for a building on their land that they would never own.

Alan Kalt, representing Churchill County, came forward to give the definition of a capital lease. There are four criteria. When the ownership interest at the end of the lease transfers to the entity, it's a capital lease. If the lease document contains a bargain purchase price, for example if at the end of the lease you can buy it for a buck, that's a capital lease. If the term of the lease is 75% or more of the estimated useful life of that asset, that would be a capital lease. The fourth criteria put out by GAAP, is if the present value of the payments over the life of the lease is 90% of the fair market value. What an auditor and an accountant would do is measure against these four criteria, if it meets one or more, it's a capital lease, if not, it's an operating lease.

Ms. Rubald suggested that maybe we need to incorporate that in an operating letter to us, local governments that is, how we distinguish between them.

Mr. Kalt responded that if it meets these accounting provisions of a capital lease, we already have statutory provisions that state: capital lease, this is what you do. He thinks of operating leases in local governments for example, copier contracts come to mind. He has not studied the detailed transaction in Elko, but he assumes somebody's accountant has checked that criteria to determine it. Ms. Hampton did say the auditing firm said capital.

Ms. Hampton replied that so did their finance people.

Ms. Rubald noted there are multiple people involved in this. The City of Phoenix created an LLC, and the LLC was the borrower of the bank.

Ms. Hampton clarified that the executors or executive director's response to Ms. Langley's inquiry, that the auditors stated it was a capital lease. It was in the MD and A, it was in the notes, as well as how the budget was set up. His response, from what she gathers, is that the auditor didn't understand the transaction and the finance people did not understand the arrangement.

Mr. Kalt asked if they provided another CPA out of Phoenix that said this was an operating lease. Ms. Hampton stated she didn't believe so.

Mr. Kalt stated that sometimes when you have a misunderstanding with auditors that it's recommended that you get a second opinion. He continued that they would have to disclose that to the auditors. It might be something the department may want to look at. In his recollection, in the quarterly economic surveys, there is a question that asks local government, if they have entered into any debt or financial arrangements, and maybe change the language there to a lease, and if it's an operating agreement they could change it there. He also stated we wouldn't want local governments to have to follow the same medium term financing for 3 years, as with copiers, or computer leases. Ms. Hampton added or school buses.

Chair Johnson stated John Sensed emailed that to him, he believes it's the same definition that the IRS uses. He questioned if capital leases are required to come before taxation to be approved.

Ms. Rubald stated she did not believe so, they are supposed to be part of the CAFR. Ms. Hampton stated that would fall into medium term when they do the financing if it exceeds to 50,000. With that said, you have the 10 years and the statute also covers anything over 10 years, you could equate that to capital leases.

Ms. Rubald added that installment purchase agreements are for greater than 10 years, and that's why she believes this has aspects of that.

Chair Johnson agreed. He stated he hasn't reviewed this particular transaction in great detail, but it seems like it has elements most like an installment purchase agreement.

Ms. Rubald asked what he thought would be most helpful to local governments. Modifying their current packets, to have a discussion on different types of leases, maybe that would be a start.

Mr. Zander suggested maybe guidance on to how those particular leases are going to be accounted for.

Chair Johnson agreed that they need to look at, including those definitions to local governments, so that they know. Also, to provide them with some guidance, or the subcommittee to the Department of Taxation so that the Department can do this, but some guidance on what would keep a capital lease from becoming an installment agreement. He stated he could see where you could cross the line when you enter into an obligation, debt being G.O. backed type bonds, with a medium term general obligations, we need to make a payment, no non appropriation clause. Then obligations would be the things we are supposed to pay, but we have the ability to decide not to appropriate it. It seems to him, that it would be fairly easy for someone intending to do a capital lease to turn that into an installment purchase agreement without realizing that has been done.

It seems to him the only difference between a capital lease and an installment purchase agreement would be that in a capital lease, the lender owns the facility, but with an installment purchase agreement, you essentially own the facility, over time. Going back to Mr. Leavitt's example of City Hall, if you did a City Hall under a capital lease, he believes the owner/contractor that owns that facility still has to pay property taxes, etc. Under an installment purchase agreement if the local government has control over the facility, even though there is a non-appropriation clause, there aren't property taxes required. He mentioned he could be wrong on that, and they may want to ask John Swenseid about. It seems to him, there is not much distinction between those two loans.

Mr. Leavitt commented to Ms. Rubald that when they were drafting language for short term financing and medium term financing regulations, we envisioned a situation that he wonders, with some of these new financing mechanisms, that people can have enough ingenuity to devise a system so they never have to get medium term financing approved, by simply calling it something else. There are numerous ways to circumvent that so that you might never have to have medium term financing approved. They originally thought that the Department would approve it if there was a guarantee that there was an ability to pay by someone outside of the local government. Now maybe we've reached a point that the local government, with their ingenuity, and how they structure the deal, can achieve the same results without having an outside party do it. He wonders if they don't have to get some kind of a revision of the statute, or an understanding at least, could go through regulations, to provide a review. It would need to be in fairly general terms because you would have to anticipate there would be new financing mechanisms that someone thinks of that are not yet contemplated. So there would be some review for the local government so they don't get in an obligation they can't pay.

He went on to state that he is afraid if they don't get something like that in, it will encourage them, when they start to see themselves going down that path, to get enter into one of these new kinds vehicles and we find ourselves worse off than we are now.

Ms. Rubald commented that she believes she is on the same page, that she is concerned about transparency.

Ms. Langley stated on the indebtedness report, there is a spot for "other". And maybe they can redefine "other" as what types of financing it may include.

Ms. Rubald commented that they would have to look at the authority for the indebtedness reports as to what "other" can include. It would be nice if we could start informing people about those kinds of financings.

Chair Johnson mentioned it seems to him that there are two kinds of concepts they have been talking about. One is guidance, and the other idea is that maybe we need to expand the list what types of obligations require either Taxation and/or debt management approval. His question is, under the idea that this subcommittee was put together, does that second thing fit with what we are supposed to be doing.

Ms. Rubald stated the second thing is more than guidance because it requires either a statutory or regulation change, which we would need to come up with a proposed solution and go through workshops if it was a regulation or if it needs to be statutory then we are going to have to find a sponsor.

Chair Johnson clarified that he is wondering is that part of what this subcommittee was charged with.

Mr. Leavitt stated he believes that what caused this subcommittee was the instant situation in Elko County. We are dealing with a new form of, whatever you call it, an operating lease, debt or an obligation. He believes the subcommittee was established to look at what we need to do, if anything with this type of a new financing arrangement. He thinks it should include guidance for the local governments as well as maybe some recommendations as to what we ought to do. Obviously we will have a full committee meeting in September some time, and likely another meeting of this group before.

Chair Johnson stated he thinks one more would wrap this up.

Mr. Leavitt went on to state that maybe they need to get some guidance from the Attorney General on what they can do right now. He is most concerned with what they can do regulation wise on the definition of some of things, whether they fit within the definition of medium term financing, the definition of capital lease, or operating lease. He is just concerned, that it's so easy, they could get some entrepreneurs that want to sell a package, and the local government is in difficulty, and it looks really good to them, they don't have to go to the department or the voters, and they could end up in a big mess.

Chair Johnson stated they aren't saying this is a bad way to finance, but without that additional oversight that we have everywhere else in this state, there does need to be some sort of ability to have someone else take a look at it. He stated part of the problem is people come in from other states where they may not have to have approval for medium term financing, but here you have too, and the local governments need to understand that.

Ms. Rubald suggested they review guideline for the MTO and see if there is any opportunity in that document to discuss the difference between operating and capital leases. They will also review their indebtedness report to see if there is an opportunity to reference these kinds of operating leases under "other". They will look at the quarterly economic report and see if there is an opportunity to put a reference in that. They will also approach the AG's office to see how far they can push it under the existing regulatory scheme, and what authority the committee has to have a regulation addressing the lease-leaseback structure and/or operating leases in general if any and bring it back to the committee. From there they can decide what part to go forward with for regulatory or statutory change. This committee may not want to address, but at least make a recommendation to CLGF for further study on that. And what can be done today with their reporting forms. She asked if that sounded like a plan.

Chair Johnson added that with the current regulatory framework, they could certainly put out a letter to local governments advising them of some of these issues. If they are doing a capital lease, that they make sure it's a capital lease. He thinks there is some guidance that can be provided without needing to worry about changing the regulations or statutes, and that's something else he thinks they should work on.

Ms. Rubald stated she would draft up a guidance letter in the format they used for the other committee, on the difference between enterprise and special revenue funds, but in this case it would be this topic. She can bring it back to the committee to discuss it, and see what else can be done.

Chair Johnson added maybe they can run it by John Swenseid as well.

Peter Keegan, Deputy Attorney, asked with respect to defined terms if there is a reference anywhere within 350 or otherwise to how leases are defined. Specifically, 350 defines installment purchase agreements and medium term obligations pretty specifically. Whereas capital leases, operational leases and perhaps lease-leaseback is not something that is specifically defined. He asked if there was a reference to GAAP at all that would be a hinge.

Ms. Rubald answered yes that was the hinge that she used in the last guidance letter that the committee, or the local government budget and finance act has to be based on generally accepted accounting principles.

Mr. Keegan suggested that general references are probably better than specific definitions. For example, if you have GAAP or other reference manuals that may be more up to date. That gives more deference to the committee to be able to define those types of obligations as they come before the committee, or require those leases, yet to be defined, to come before the committee to be evaluated under GAAP or other principles. That might be more guiding in terms of what those obligations are and how they should be evaluated. He's not sure if any of that makes sense, but he's here, so he is offering.

Chair Johnson stated if he understands what Mr. Keegan is saying, he thinks that's what he envisioned. Basically if the obligation meets 3 of these 5 criteria that they lay out, then it needs to be authorized. It doesn't mean they can't do it, just that they need to through those steps. Without being specific, some broad criteria that states they need to have another level of oversight on this particular type of a deal.

Mr. Keegan noted it seems like the objective is to obtain oversight. He's looking at a medium financing checklist. Somewhere a simple change could be at a statutory or regulation level. Leasing obligations, or some other term, need to be reviewed under GAAP or other principles in order to ensure compliance with debt ratios or however you want to define it. It would give the committee to require something to be filled out, presented or reviewed rather than phone calls from these entrepreneurs stating something does not have to be reviewed. It could be simply pointed at, that no, these types need to be carefully reviewed to ensure they aren't going to put local governments in turmoil.

Mr. Leavitt remembers years ago, with one of the statutes, they almost wrote it exactly the way some of the accepted accounting principles were at that time. Low and behold, they changed the accepted accounting principles and they had to go back and change the statutes, and it's not something they want to have to do. Leases are good example. Over the years, the way they define leases change. He is afraid if they adopt this language, it would change in a year or two, and they would be back at doing it again.

Ms. Hampton stated operating leases typically run annually, every three years or so. She suggested something change in their references using the time frame as a determining factor as to if they need to come to the Department of Taxation, or somebody for review.

Mr. Keegan again noted he is not an expert in this field, but keeping it as general as possible, referencing the outside authorities, in other instances he has seen attempts to make regulatory changes to nail something down to a specific T, it always ends up in future amendments and problems with redefining things as the tide shifts. If there are outside entities that are constantly updating things and educating individuals on the ever evolving financial instruments, then referencing those as a general way for this body to evaluate obligations in a lease format, he thinks is the best way to go. He stated he will review 350 with Bill and Dawn, and he's sure Dawn will come back with something at the next committee or subcommittee meeting.

Chair Johnson asked Ms. Rubald if they need to take in action on this.

Ms. Rubald answered no, that they will create some guidance letters and identification of other opportunities to address this and bring it back to the committee. She noted Mr. Keegan mentioned what he will do, and we will bring that back as well, and the committee can decide how to fine tune that.

ITEM 4. BRIEFING TO AND FROM THE SUBCOMMITTEE ON LOCAL GOVERNMENT FINANCE AND LOCAL GOVERNMENT FINANCE STAFF

a) Discussion of Matters Affecting Local Governments

b) For Possible Action: Schedule Date and Review Agenda Topics for the Next Meeting

Ms. Rubald stated there is nothing to brief them on, so they could move on to the next date. She asked if they had any preference.

Chair Johnson stated it would be best if they meet before the next CLGF Meeting, Mr. Leavitt agreed.

She volunteered the 1st or the 2nd week in September, or sooner if they would like.

Chair Johnson said part of that depends on how long it will take her folks to put stuff together.

Ms. Rubald stated sometime after the 8th of September. Chair Johnson asked if they could do the 12th, Ms. Rubald, Mr. Leavitt, and Mr. Zander agreed.

Ms. Rubald added that staff will make the arrangements and get out a notice for the 12th.

ITEM 5. PUBLIC COMMENT

There was no public comment.

ITEM 6. For Possible Action: ADJOURNMENT

The meeting was adjourned at 10:04 a.m.