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Guidance Letter 16-004

Date: September 27, 2016

To: Local Government Finance Officers; Local Government Auditing Firms

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: Review of Current and Pending GASB standards on Lease Accounting; Requirements for Reporting Installment-purchase Agreements; and Types of Installment-purchase Agreements and Medium Term Obligations Subject to Approval by the Department of Taxation

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.

Guidance Letter 16-004 was approved by the Committee on Local Government Finance on September 26, 2016.

DISCUSSION

Statutory and Regulatory Framework

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.

NRS 350.013 requires the annual submission to the Department of Taxation and to the appropriate Debt Management Commission, of a report of the outstanding general obligation debt, other general obligations or special obligations, or levies of any special elective tax. In counties whose population is 100,000 or more, the statements may be updated more often than once a year to include items related to installment purchases that do not count against a debt limit.

NAC 350.010 describes the information which must be included in the Annual Statement and Report by municipalities required by NRS 350.013. In addition to various schedules concerning general obligation debt, the report must also include the amount of any other debts, such as mortgages or capital leases, which the governing body contemplates incurring before the end of the fiscal year following the date of the schedule.

NRS 350.014(1) requires the submission of proposed installment-purchase agreements with a term of more than 10 years to be approved by the appropriate debt management commission.

Governmental Accounting Standards Board Statements

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. 34 establishes the components of basic financial statements for general purpose governments. Statement No. 62 provides lease accounting standards for reporting leases in local government financial statements, including criteria for determining whether a lease is a capital or operating lease. GASB 62 criteria are useful in classifying leases subject to reporting and/or approval by the Department.

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 (“ASU”) 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.

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:

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

³ GASB Statement 62, Paragraph 211, p. 87.

- 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)
- 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 Agreements⁷:

An Installment-purchase Agreement is defined as an agreement for the purchase of real or personal property by installment or lease. In addition, an installment-purchase agreement includes other transactions 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

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

⁷ Nevada Revised Statute (NRS) 350.0055

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 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.

⁸ NRS 350.800(1)(a-b)

- 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.

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

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 proposed GASB statement, 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 those leases recorded on the financial statements consistent with the requirements of NRS 350.013(4), NRS 350.014(1), and NAC 350.010.
3. A lease reported as a capital lease in an agency's CAFR under GASB which does not otherwise meet the definition of a capital lease or installment purchase agreement under Nevada Revised Statutes must still be reported to the Department of Taxation under "Other" for purposes of the Indebtedness Report. For example, if the lease term is greater than 75% of the estimated economic life of the equipment; or the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the leased property's fair market value, but title does not transfer and there is no bargain purchase option, the lease meets GASB standards as a capital lease. If the resolution authorizing such a lease meets the conditions of NRS 350.087, the lease must also be approved by the Department pursuant to NRS 350.089.
4. 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.
5. 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 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.
6. Guidelines and references with regard to the procedures for procuring approval of 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/
7. 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.

8. Evaluate the lease agreement to determine whether the lease or rental payments are credited towards the purchase price. If the title to the subject property and the buildings thereon vest in the local government at the expiration of the lease, either automatically or upon written notice or request by the local government with no further payment, the lease should be considered a capital lease requiring approval by the Department.

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. 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. Because the local government may simply request title be transferred at the expiration of the Facilities Lease, the transaction may constitute an option to purchase in which the lease payments are considered credited towards the purchase price for purposes of NRS 350.0055.

In certain circumstances, the local government should consider whether the vesting of title at the end of the Site Lease has the same effect, i.e., where the effect of the expiration of the Site Lease is to provide the local government with the ownership of the Facilities that are leased under the Facilities Lease at a price which reflects crediting of the Facilities Lease payments towards the purchase price of the Facilities. In these situations, the transaction as a whole may be the equivalent of an installment purchase agreement under NRS 350.0055. For example if the Facilities Lease and Site Lease have identical terms and on expiration of the Site Lease, the local government will own the Facilities leased under the Facilities Lease without paying any additional consideration, the transaction as a whole appears to be one where the local government has paid the price of the Facilities leased under the facilities lease in installments during the term of the two leases, as it owns the Facilities at the end of that term, without paying any additional sum. In such a situation, the local government should follow the procedure in NRS for obtaining approval of an installment purchase agreement prior to entering into the two leases.¹⁰

9. The local government should consult with its auditors and the Department as to the proper classification of the type of transaction discussed above or other unusual transactions prior to completion of the obligation in order to (1) avoid any potential reporting violations and (2) properly reflect the transaction in the financial statements of the local government.

¹⁰ This paragraph was added after approval by CLGF on 9-26-2016 in order to incorporate a suggestion from bond counsel; and will be presented to CLGF at its next meeting for ratification.

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 350.013 Municipalities to submit annually statement of current and contemplated general obligation debt and special elective taxes, statement of debt management policy, plan for capital improvement or alternate statement and certain information regarding chief financial officer; update of information; exceptions

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.

Nevada Administrative Code, Chapter 350

NAC 350.010 Annual statement and report by municipalities.

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://tax.nv.gov/LocalGovt/PolicyPub/Guidance_Letters/