SAO State Accounting Office

Statewide Accounting Policy & Procedure

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Section:	Financial Accounting and Reporting Policies & Procedures	**Revision Date:** 06/30/2023
Sub-section:	Leases and SBITA	
Policy Title:	Leases - Lessee & Lessor Accounting	

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Accounting Policy Summary:

A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition should be accounted for in accordance with generally accepted accounting principles (GAAP) as promulgated by the Governmental Accounting Standards Board's (GASB) lease guidance, GASB Statement 87. This policy provides accounting and reporting guidance for lessees in accordance with GASB 87.

However, GASB 87 and this policy do not apply to certain types of leases and contract as follows:

- Leases of intangible assets, including rights to explore for or to exploit natural resources such as oil, gas, and minerals and similar nonregenerative resources; licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights; and licensing contracts for computer software. In sublease transactions, however, this Statement does apply to the intangible right to use assets that are created by the original leases of tangible underlying assets.
- Leases of biological assets, including timber, living plants, and living animals.
- Leases of inventory.
- Contracts that meet the definition of a service concession arrangement in paragraph 6 of Statement No. 94, Public-Private and Public-Public Partnerships and Availability Payment Arrangements.
- Leases in which the underlying asset is financed with outstanding conduit debt, unless both the underlying asset and the conduit debt are reported by the lessor.
- Supply contracts, such as power purchase agreements.

As of fiscal year 2023, agencies are no longer required to submit data to the State Accounting Office for leased copiers, postage meters or water coolers. These leases are considered insignificant and therefore will be excluded from the Annual Comprehensive Financial Report. Agencies that are required to have stand-alone financials should evaluate if these right-to-use assets are significant to their financials and include if applicable.

Accounting Policy and Requirements:

The accounting and financial reporting guidance for leases in GASB 87 is based on the foundational principle that leases are financings. In a lease transaction, a lessee receives the legal right to use an underlying asset (the asset that is subject to the lease, such as a vehicle or building) at the commencement of the lease term. In exchange, the lessee promises to make payments over time for the right to use that underlying asset. Therefore, the lessee has financed the acquisition of that legal right and recognizes a lease asset that is amortized along with a lease liability that is reduced as payments are made.

Conversely, a lessor receives payments over time for transferring to the lessee the legal right to use the underlying asset and recognizes deferred inflow of resources that is amortized and a corresponding lease receivable that is reduced as payments are received.

Recognition and Measurement

Control of the right to use the underlying asset – In order to have control of the right to use the underlying asset, organizations of the State must have both of the following:

- The right to obtain the present service capacity from use of the underlying asset as specified in the contract.
- The right to determine the nature and manner of use of the underlying asset as specified in the contract.

Determination of the Lease Term – the lease term is the period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period), plus the following periods, if applicable:

- Periods covered by a lessee's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option.
- Periods covered by a lessee's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option.
- Periods covered by a lessor's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessor will exercise that option.
- Periods covered by a lessor's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessor will not exercise that option.
- Periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party (or if both parties have to agree to extend) are cancelable periods and are excluded from the lease term. For example, a rolling month-to-month lease, or a lease that continues into a holdover period until a new lease contract is signed, would not be enforceable if both the lessee and the lessor have an option to terminate and, therefore, either could cancel the lease at any time. Provisions that allow for termination of a lease due to (1) purchase of the underlying asset, (2) payment of all sums due, or (3) default on payments, are not considered termination options.

Fiscal Funding or Cancellation Clause – Part of determining a lease term requires that applicable legal restrictions be considered. Legal restrictions applicable to State organizations, which are included in the State Constitution, prohibit State organizations from entering into payables beyond the current fiscal year. In order to comply with the Constitution, lease agreements typically contain a fiscal funding or cancellation clause that permits a State organization to terminate an agreement on an annual basis if funds are not appropriated to make required payments.

However, a fiscal funding or cancellation clause should affect the lease term only when it is reasonably certain that the clause will be exercised (i.e., fiscal funding clauses are to be ignored unless the State organization is reasonably certain it will be exercised).

Additionally, lessees and lessors should reassess the lease term only if one or more of the following items related to fiscal funding clauses occur:

- The lessee elects to exercise an option even though it was previously determined that it was reasonably certain that the lessee would not exercise that option.
- The lessee elects not to exercise an option even though it was previously determined that it was reasonably certain that the lessee would exercise that option.
- An event specified in the lease contract that requires an extension or termination of the lease takes place.

Short-Term Leases - A short-term lease is a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised. For a lease that is cancelable by either the lessee or the lessor, such as a rolling month-to-month lease or a year-to-year lease, the maximum possible term is the noncancelable period, including any notice periods. **Short-term leases do not meet the definition of a lease.**

Contracts that transfer ownership – a contract that transfers ownership of the underlying asset to the lessee by the end of the contract and does not contain termination options (may contain a fiscal funding or cancellation clause that is not reasonably certain of being exercised) should be reported as a financed purchase of the underlying asset by the lessee (i.e., these are not reported as a lease) or sale of the asset by the lessor.

Leasehold Improvements – A leasehold improvement is an improvement made to a leased building by a State organization that has the right to use the leasehold improvement over the term of the lease. This improvement will revert back to the lessor at the expiration of the lease term. Leasehold improvements should not include normal maintenance and repairs.

- Leasehold improvements do not have a residual value. Leasehold improvements made in lieu of rent should be expensed in the period incurred.
- Based on State law and several Attorney General Opinions, State organizations cannot use State funds to make a permanent leasehold improvement unless the leased property falls into any of the categories below:
    - Owned by the State, or
    - Held by the State in fee simple or under a quitclaim deed with a reversionary interest in the federal government, or
    - Held by the State under a long-term federal license with a reversionary interest in the federal government.
- The reversion of a permanent leasehold improvement constructed with State funds to an entity other than the State or the federal government is considered a gratuity which is prohibited by the Georgia Constitution.

Lease Modifications – The provisions of a lease contract may be amended while the contract is in effect. Amendments modify the provisions of the lease contract. Examples of amendments to lease contracts include:

- changing the contract price
- lengthening or shortening the lease term
- adding or removing an underlying asset

The lessee and lessor should account for an amendment during the reporting period resulting in a modification to a lease contract as a separate lease (that is, separate from the most recent lease contract before the modification) if both of the following conditions are present:

- The lease modification gives the lessee an additional lease asset by adding one or more underlying assets that were not included in the original lease contract.
- The increase in lease payments for the additional lease asset does not appear to be unreasonable based on the terms of the amended lease contract and professional judgment, maximizing the use of observable information (for example, using readily available observable stand-alone prices).

Unless a modification is reported as a separate lease as provided in paragraph above, an amendment to a lease contract should be considered a lease modification, unless the lessee's right to use the underlying asset decreases, in which case it would be a partial or full lease termination. A lease termination should be accounted for by reducing the carrying values of the lease liability and lease asset by a lessee with any difference being recognized as a gain or loss.

A lease modification that does not qualify as a separate lease should be accounted for by remeasuring the lease liability and adjusting the related lease asset by a lessee.

If prior to the expiration of the lease term a change to the provisions of a lease results from a debt refunding by the lessor, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee, the change should be accounted for as follows:

- If a change to the provisions of a lease results from a debt refunding by the lessor, including an advance refunding that results in a defeasance of debt:
  - The lessee should adjust the lease liability to the present value of the future lease payments under the revised lease using the effective interest rate applicable to the revised lease contract. The resulting difference should be reported as a deferred outflow of resources or a deferred inflow of resources. The deferred outflow of resources or the deferred inflow of resources should be recognized as an adjustment to an outflow of resources (for example, as an increase or decrease to interest expense) in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter
  - The lessor should adjust the lease receivable to the present value of the future lease payments based on the interest rate applicable to the revised lease contract and also should adjust the deferred inflows of resources. The adjustment to the deferred inflow of resources should be recognized as inflows of resources or outflows of resources (for example, gain or loss) over the remaining life of the old debt or the life of the new debt, whichever is shorter.
- If the provisions of a lease are changed in connection with an advance refunding by the lessor that results in a defeasance of debt and the lessee is obligated to reimburse the lessor for any costs related to the refunded debt that have been or will be incurred (such as an unamortized discount or a call premium):
  - The lessee should recognize those costs in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.
  - The lessor also should systematically recognize, as inflows of resources (for example, revenue), any reimbursements to be received from the lessee for costs related to the refunded debt (such as an unamortized discount or a call premium) over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Subleases or Sale-Leaseback Transactions – Subleases should be treated as transactions separate from the original lease. The original lessee that becomes the lessor in a sublease should account for the original lease and the sublease as separate transactions, as a lessee and lessor, respectively.

- A transaction qualifies for sale-leaseback accounting only if it includes a sale. Otherwise, it is a borrowing. The sale and lease portions of a transaction should be accounted for as separate sale and lease transactions, except that any difference between the carrying value of the capital asset that was sold and the net proceeds from the sale should be reported as a deferred inflow of resources or a deferred outflow of resources and recognized over the term of the lease.
- A lease-leaseback transaction should be accounted for as a net transaction.

Measurement – Under GAAP accrual accounting, a lessee should recognize a lease liability and an intangible right-to-use lease asset (a capital asset hereinafter referred to as the lease asset) at the commencement of the lease term, unless the lease is a short-term lease, or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives as defined below). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs. Short-term lease payments are recorded as outflows of resources (for example, expense).

Valuation of the Lease Liability and Lease Receivable

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

- Fixed payments
- Variable payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the commencement of the lease term.
- Variable payments that are fixed in substance.
- Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees.
- The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option.
- Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause.
- Any lease incentives receivable from the lessor.
- Any other payments that are reasonably certain of being required based on an assessment of all relevant factors.

Lease Receivable - A lessor initially should measure the lease receivable at the present value of payments expected to be made during the lease term, reduced by any provision for estimated uncollectibles. Measurement of the lease receivable should include the following, if required by a lease:

- Fixed payments
- Variable payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the commencement of the lease term.
- Variable payments that are fixed in substance.
- Residual value guarantee payments that are fixed in substance.
- Any lease incentives payable to the lessee

Variable payments – Payments based on future performance of the lessee or usage of the underlying asset should not be included in the measurement of the lease liability or lease receivable. Rather, those variable payments should be recognized as outflows of resources (for example, expense) in the period in which the payable for those payments is incurred. However, any component of those variable payments that is fixed in substance should be included in the measurement of the lease liability.

Remeasurement **–** The lease liability and lease receivable should be remeasured if certain changes have occurred at or before the financial reporting date and the changes are expected to significantly affect the amount of the lease liability or lease receivable. Generally, the lease asset should be adjusted by the same amount as the lease liability. See "Lease Modifications" section above for more details.

Lease Incentives **–** Lease incentives are payments made to, or on behalf of, the lessee, for which the lessee has a right of offset with its payable to the lessor, or other concessions granted to the lessee. A lease incentive is equivalent to a rebate or discount and includes assumption of a lessee's preexisting lease payables to a third party, other reimbursements of lessee costs, rent holidays, and reductions of interest or principal charges by the lessor.

- Lease incentives reduce the amount that a lessee is required to pay for a lease. Lease incentives that provide payments to, or on behalf of, a lessee at or before the commencement of a lease term are included in initial measurement by directly reducing the amount of the lease asset.
- Lease incentive payments to be provided after the commencement of the lease term should be accounted for by lessees as reductions of lease payments for the periods in which the incentive payments will be provided. Those payments should be measured by lessees consistently with the lessee's lease liability.
    - Accordingly, lease incentive payments to be provided after the commencement of the lease term are included in initial measurement and any remeasurement if they are fixed or fixed in substance, whereas variable or contingent lease incentive payments are not included in initial measurement.

Incremental Borrowing Rate – Future lease payments and receipts should be discounted using the interest rate the lessor charges the lessee, which may be the interest rate implicit in the lease. If the interest rate cannot be readily determined by the lessee, the lessee's estimated incremental borrowing rate (an estimate of the interest rate that would be charged for borrowing the lease payment amounts during the lease term, which could be the State's rate) should be used.

Lease Asset **-** A lessee initially should measure the lease asset as the sum of the following:

- The amount of the initial measurement of the lease liability, as described above.
- Lease payments made to the lessor at or before the commencement of the lease term, less any lease incentives from the lessor at or before the commencement of the lease term.
- Initial direct costs that are ancillary charges necessary to place the lease asset into service.

Deferred Inflow of Resources **-** A lessor initially should measure the deferred inflow of resources as follows:

- The amount of the initial measurement of the lease receivable
- Lease payments received from the lessee at or before the commencement of the lease term that relate to future periods (for example, the final month's rent), less any lease incentives paid to, or on behalf of, the lessee at or before the commencement of the lease term.

Amortization and Allocation of Lease Liabilities **–** A lease asset should be amortized in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset, except if the lease contains a purchase option (described in paragraph below). The amortization of the lease asset should be reported as an outflow of resources (for example, amortization expense), which may be combined with depreciation expense related to other capital assets for financial reporting purposes.

> If a lease contains a purchase option that the lessee has determined is reasonably certain of being exercised, the lease asset should be amortized over the useful life of the underlying asset. In that circumstance, if the underlying asset is nondepreciable, such as land, the lease asset should not be amortized.

Contracts with Multiple Components and Contract Combinations – a government should generally account for the lease and nonlease components of a lease as separate contracts. Payments related to the right to use the asset are considered part of the lease, whereas payments for items not related to the right to use the asset are considered nonlease components and are not considered part of the lease. Examples of nonlease components include the cost of common area maintenance, taxes/insurance, consumable supplies (paper/toner), or a service contract.

- If a lease involves multiple underlying assets, lessees should account for each underlying asset as a separate lease contract. To allocate the contract price to different components, lessees should use contract prices for individual components as long as they do not appear to be unreasonable based on professional judgment or use professional judgment to determine their best estimate if there are no stated prices or if stated prices appear to be unreasonable.
- If determining a best estimate is not practicable, multiple components in a lease contract should be accounted for as a single lease unit.
- Contracts that are entered into at or near the same time with the same counterparty and that meet certain criteria should be considered part of the same lease contract and should be evaluated in accordance with the guidance for contracts with multiple components.
- If a contract does not include prices for individual components, or if any of those prices appear to be unreasonable, lessees should use professional judgment to determine their best estimate for allocating the contract price to those components, maximizing the use of observable information. If it is not practicable to determine a best estimate for price allocation for some or all components in the contract, a government should account for those components as a single lease unit.
- If multiple components are accounted for as a single lease unit, the accounting for that unit should be based on the primary lease component within that unit. For example, the primary lease component's lease term should be used for the unit if the lease components have different lease terms.

Basis of Accounting

Organizations included in the State reporting entity are required to maintain their accounting records in a manner that provides for the preparation of both GAAP financial statements and budgetary statements. Day-to-day operations may be accounted for using a budgetary/statutory basis of accounting, which is also used for preparing the year-end BCR. The primary statements in the year-end Annual Comprehensive Financial Report (ACFR), however, are prepared using different bases of accounting, the GAAP bases: modified accrual and accrual.

<u>Statutory Basis</u>

Periodic payments on leases are recognized as expenditures (lessee) or revenue (lessor) on the statutory basis of accounting. Payments should be recorded as lease principal and interest expenditures. Receipts should be recorded as rental income.

GAAP Modified Accrual Basis

- Lessees:
    - Governmental funds should report an expenditure and other financing source in the period the lease is initially recognized. These should be measured in accordance with the requirements for measuring the lease liability and lease receivable (described above). In subsequent periods, payments should be accounted for as principal and interest expenditures and receipts should be accounted for as revenue. Amortization of interest should not be recognized in the fund level financial statements.
- Lessors:
    - A lease receivable and deferred inflow of resources should be recorded at inception of the lease and periodic lease payments should be recorded as revenue and a reduction to the lease receivable. A lessor subsequently should recognize the deferred inflow of resources as inflows of resources (for example, revenue) in a systematic and rational manner over the term of the lease).

GAAP Accrual Basis

Proprietary funds, fiduciary funds, component units using the accrual basis, and the government-wide financial statements should report capital assets as well as long and short-term payables on the statement of net position.

- Lessees:
    - A lease asset and lease liability should be recorded at inception of the lease and periodic lease payments should be recorded as interest expense and a reduction to the lease liability. Additionally, amortization expense related to the leased asset should be recorded.
- Lessors:
    - A lessor should not derecognize the asset underlying the lease but should continue to apply other applicable guidance to the underlying asset, including depreciation and impairment. However, if the lease contract requires the lessee to return the asset in its original or enhanced condition, a lessor should not depreciate the asset during the lease term.

General Accounting Procedures:

The following procedures are used by organizations in the State of Georgia reporting entity to meet the requirements for statutory and GAAP reporting purposes.

Management at state reporting organizations must evaluate every contract or agreement to determine whether the transaction should be treated as a lease and provide the required information to SAO. Currently, SAO uses a lease accounting software to manage the lease reporting process for state organizations that are not subject to external CPA/DOAA audits, thereby standardizing control over lease accounting and financial reporting. Organizations should be able to reconcile current year information provided to SAO for lease payments to lease payments recorded in the general ledger. State organizations subject to external CPA audited organizations should ensure that controls are in place at their locations to ensure compliance with this policy. The following guidance also applies when identifying and evaluating transactions.

Leases within the Reporting Entity – If a state organization is part of the primary government for financial reporting purposes and enters into a lease agreement where the lessor entity (public authority, department, agency, division, etc.) is also part of the primary government, then the lease should not be reported as lease. The payments for these agreements should be considered ordinary operating expenditures/expenses by the lessee organization. For example, agreements between Georgia Building Authority (GBA) and other organizations included in the State's primary government should not be reported as leases in the statewide ACFR.

- If any state organization enters into a lease agreement where the lessor is either a) a discretely presented component unit or b) a public organization that is ***not*** part of the governmental unit entity for financial reporting purposes, then the lease should be treated in the same manner as any other lease agreement of the State.
- A current list of organizations within the primary government can be found using the following link: https://sao.georgia.gov/statewide-reporting/reporting-structure-chart-accounts

Reflecting the Lease Assets and Liabilities Associated with Leases - For State organizations that are not subject to external CPA audits:

- Leased Assets – Leased assets are **not** required to be entered into the asset management module of the statewide financial system. The values of these assets for ACFR reporting purposes, including amortization information, are derived from information provided by reporting organizations that is input into the lease accounting software managed by SAO. If such an organization chooses to use the asset management module for inventory tracking purposes of lease acquired assets, then the profile ID for these leased assets should be set to track the assets as small value assets with "zero-dollar" values. The required entries to record these assets are prepared by SAO for reporting on a statewide basis during the annual ACFR process.
    - For State organizations that are subject to external CPA audits, appropriate records should be maintained to ensure that applicable expenditures, other financing sources, asset values and amortization for leased items can be reported properly under each basis of accounting in compliance with this policy.
- Lease Liabilities - the valuation of the payable at lease inception and the subsequent allocation of minimum lease payments between interest expense and reduction of principal are derived from information provided by reporting organizations that is input into the lease accounting system managed by SAO. The required entries to record these lease liabilities and related interest are prepared by SAO for reporting on a statewide basis during the annual ACFR process.
    - For State organizations that are subject to external CPA audits, appropriate records should be maintained to ensure that the interest, principal reduction, and long-term lease liability for leases can be reported properly under the accrual basis of accounting in compliance with this policy.

Reflecting the Lease Receivable and Deferred Inflow Associated with Leases – For State organizations that are not subject to external CPA audits, the valuation of the receivable and deferred inflow at lease inception and the subsequent receipt of revenue are derived from information provided by reporting organizations that is input into the lease accounting system managed by SAO. The required entries to record these lease receivables and deferred inflows are prepared by SAO for reporting on a statewide basis during the annual ACFR process.

- For State organizations that are subject to external CPA audits, appropriate records should be maintained to ensure that the revenue and long-term lease receivable for leases can be reported properly under the accrual basis of accounting in compliance with this policy.

Accounting Transactions and Journal Entries

State reporting organizations using the statewide financial system are required to use the general ledger chartfields for each expenditure and corresponding payable transactions for lessee and revenue and receivable transactions for lessor. These chartfields may be different for budgetary reporting and GAAP transactions, such that journal entries may be required to convert between the various bases of accounting required for reporting. Under GAAP, leases are accounted for in a manner similar to debt transactions. Significant variance between GAAP and the State's budgetary basis of accounting are discussed below.

The journal entry examples provided in this section are based on accounts listed in the State Chart of Accounts (SCOA) which is posted on the reporting structure page of the SAO website. The link to the SCOA is sao.georgia.gov/statewide-reporting/reporting-structure-chart-accounts. As stated above, State organizations that are subject to external CPA audits are responsible for properly classifying leases and for preparing all entries needed for reporting under each basis of accounting that applies to the organization (statutory, modified accrual and/or accrual). Organizations that are not subject to external CPA audits are responsible for recording lease transactions under the statutory basis of accounting and for supplying information to SAO as described in the Year-end Accounting Procedures section below. SAO classifies the leases and prepares journal entries to report under the modified accrual and accrual bases of accounting for organizations that are not subject to external CPA audits.

Lease Example - Lessee

Assume that equipment is leased for a three-year lease term and the lease meets the criteria for treatment as a lease. Also, assume that the following payment and amortization schedule applies.

Amortization Schedule	**Principal**	**2% Annual Interest***	**Total Payment**	**Outstanding Principal Balance**
Lease Inception				$ 30,000
Year 1	$ 9,800	$ 500	$ 10,300	20,200
Year 2	10,000	300	10,300	10,200
Year 3	10,200	100	10,300	-
	$ 30,000	$ 900	$ 30,900	
Present Value of Minimum Lease Payments at 2%			$ 30,000	

Statutory Basis Journal Entry

To record the lease payments for the first year of the lease term (assumes no encumbrance was recorded):

Debit	$9,800	Lease – Principal Payments (applicable expenditure account for lease payment)
Debit	$ 500	Lease – Interest Payments (716xxx) *
Credit	$10,300	Cash (10xxxx) or Accounts Payable (200xxx) as appropriate

This entry reduces fund balance. A similar entry is recorded each year of the lease term, however, the split between principal and interest changes each year, as demonstrated in the table above.

Modified Accrual Basis Journal Entry

To record the acquisition cost of the asset/value of the lease in governmental funds. This entry is recorded in ***only the initial year*** of the lease term and presents the activity as a capital outlay expenditure:

Debit	$30,000	Expenditure (applicable expenditure account)
Credit	$30,000	Other Financing Sources – Leases (476xxx)

This entry does not affect fund balance.

Statutory Basis Journal Entry

To record the entry in the second year of the lease:

Debit	$10,000	Lease – Principal Payments (619xxxx, 648xxxx, & 819xxxx)
Debit	$ 300	Lease – Interest Payments (716xxx) *
Credit	$10,300	Cash (10xxxx) or Accounts Payable (200xxx) as appropriate

*Organizations that complete the "Lease Agreement Data" form as discussed in Year-end Accounting Procedures below may record the entire payment as a debit to Rent Expenditure. The calculation and recording of the interest portion of the payment is not necessary.

Accrual Basis Journal Entries

The following entries are needed to adjust modified accrual basis records to the accrual basis of accounting. Amounts reflect activity for Year 1 based on the above amortization schedule.

To record the present value of minimum lease payments as a leased asset and to reflect a long-term liability for the lease liability:

Debit	$30,000	Leased Asset (Various accounts in the 17xxxx series)
Credit	$30,000	Lease Liability – Noncurrent (286001)

To record amortization expense related to the right to use, assuming a three-year useful life with no salvage value:

Debit	$10,000	Amortization Expense (740002)
Credit	$10,000	Accumulated Amortization (Various accounts in the 17xxxx series)

To reduce rent expense recorded under the statutory basis by the amount related to principal payments:

Debit	$9,800	Lease Liability – Noncurrent (286001)
Credit	$9,800	Lease – Principal Payments (619xxxx, 648xxxx, & 819xxxx)

To reclassify the current portion of the lease liability from noncurrent liabilities:

Debit	$10,000	Lease Liability – Noncurrent (286001)
Credit	$10,000	Lease Liability – Current (257xxx)

To reverse the entry made under the modified accrual basis since it does not apply to the accrual basis:

Debit	$30,000	Other Financing Sources – Leases (476xxx)
Credit	$30,000	Capital Outlay Expenditure (Various accounts in the 72xxxx series)

This entry does not affect net position.

In subsequent years, additional entries are required to reinstate beginning balances for any leases that may have existed at the end of the prior year. Beginning balances for leased assets, accumulated amortization, and lease liabilities are reinstated with an offset to beginning net position.

To reinstate the Year 1 ending asset balances as the beginning balances for Year 2:

Debit	$30,000	Leased Asset (Various accounts in the 17xxxx series)
Credit	$10,000	Accumulated Amortization (Various accounts in the 17xxxx series)
Credit	$20,000	Adjustment to Net Position – July 1

To reinstate the Year 1 ending lease liability balance as the beginning balance for Year 2 – Reflect combined current and noncurrent portions as noncurrent:

Debit	$20,200	Adjustment to Net Position – July 1
Credit	$20,200	Lease Liability – Noncurrent (286xxx)

Lease Example - Lessor

Assume that equipment is leased for a three-year lease term and the lease meets the criteria for treatment as a lease. Also, assume that the following payment and amortization schedule applies.

Amortization Schedule	**Principal**	**2% Annual Interest***	**Total Receipts**	**Outstanding Principal Balance**
Lease Inception				$ 30,000
Year 1	$ 9,800	$ 500	$ 10,300	20,200
Year 2	10,000	300	10,300	10,200
Year 3	10,200	100	10,300	-
	$ 30,000	$ 900	$ 30,900	
Present Value of Minimum Lease Payments at 2%			$ 30,000	

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Statutory Basis Journal Entry

To record the lease receipts for the first year of the lease term:

Debit	$ 10,300	Cash (10xxxx)
Credit	$ 500	Interest Income (various revenue accounts)
Credit	$ 9,800	Lease Revenue (various revenue accounts)

This entry increases fund balance. A similar entry is recorded each year of the lease term, however, the split between principal and interest changes each year, as demonstrated in the table above.

To record the entry in the second year of the lease:

Debit	$ 10,300	Cash (10xxxx)
Credit	$ 300	Interest Income (various revenue accounts)
Credit	$ 10,000	Lease Revenue (various revenue accounts)

*Organizations that complete the "Lease Agreement Data" form as discussed in Year-end Accounting Procedures below may record the entire receipt as a credit to Lease Revenue. The calculation and recording of the interest portion of the payment is not necessary.

Modified Accrual Basis Journal Entries

Amounts reflect activity for Year 1 based on the above amortization schedule.

To record the present value of minimum lease receipts as a lease receivable and to reflect a deferred inflow of resources:

Debit	$	30,000	Lease Receivable – Current
Credit	$	30,000	Deferred Inflows – Noncurrent

To reduce rent revenue recorded under the statutory basis by the amount related to principal receipts:

Debit	$	9,800	Lease Revenue
Credit	$	9,800	Lease Receivable – Current

To reclassify the current portion of the lease receivable from noncurrent:

Debit	$	10,000	Lease Receivable – Noncurrent
Credit	$	10,000	Lease Receivable – Current

To recognize the deferred inflow of resources as revenue:

Debit	$	9,800	Deferred inflows of resources
Credit	$	9,800	Lease Revenue

In subsequent years, additional entries are required to reinstate beginning balances for any leases that may have existed at the end of the prior year. Beginning balances for lease receivables and deferred inflows of resources are reinstated with an offset to beginning fund balance.

To reinstate the Year 1 ending lease receivable and deferred inflows or resources balances as the beginning balance for Year 2 – Reflect combined current and noncurrent portions as noncurrent:

Debit	$	20,200	Lease Receivable
Credit	$	20,200	Deferred inflows or resources

Accrual Basis Journal Entries

To record depreciation expense related to the underlying asset, assuming a three-year useful life with no salvage value:

Debit	$	10,000	Depreciation Expense (740xxx)
Credit	$	10,000	Accumulated Depreciation (Various accounts in the 17xxxx series)

To reinstate the Year 1 ending asset balances as the beginning balances for Year 2:

Debit	$	30,000	Asset (Various accounts in the 17xxxx series)
Credit	$	10,000	Accumulated Depreciation (Various accounts in the 17xxxx series)
Credit	$	20,000	Adjustment to Net Position – July 1

Year-end Accounting Procedures

State organizations must coordinate with the SAO statewide accounting and reporting group to confirm that the appropriate journal entries are recorded to properly report leases under the modified accrual and accrual bases of accounting at year-end. All required information must be provided to SAO in accordance with the annual year-end reporting calendar. Organizations may provide their information either by completing the "Lease Agreement Data" form for year-end reporting or by providing independently audited financial statements that include required lease disclosures. Organizations providing independently audited financial statements should comply with this policy. The "Lease Agreement Data" form, with detailed instructions, is available for download from the Year-End Reporting page of the SAO website: (Year-End Forms | State Accounting Office of Georgia).

Funds that operate on a statutory basis must convert their accounting activity to the modified accrual and/or accrual bases of accounting for the ACFR. Proprietary and fiduciary funds that do not operate on a statutory basis use the accrual basis of accounting throughout the year. If GAAP financial statements are not provided, SAO must be furnished with information to meet the necessary GAAP reporting requirements previously discussed.

Statutory Basis for Budgetary Compliance Reporting - Periodic payments and receipts on leases are recognized as expenditures and revenue on the statutory basis of accounting.

- The expenditure is recognized at the earlier of the time the funds are encumbered (i.e., when purchase orders or other contractual payables have been executed) or the time the rights under the lease have been received. Accruals are required at year-end for unencumbered lease periods that have lapsed but for which payments have not been processed through the accounts payable subsystem. A reclassification from encumbrance liability to accounts payable is required for any encumbered periods that have lapsed but for which payments have not yet been processed through the accounts payable subsystem by year-end.
- The revenue is recognized when the receipt of the lease payment or cash has been received.

Converting to GAAP Modified Accrual Basis for ACFR Reporting - Governmental funds recognize periodic payments and receipts on leases as expenditures and revenue in the period incurred.

- Lessee:
  - Even though leased assets and long-term liabilities are not reported in fund financial statements under the modified accrual basis of accounting, entrance into a lease liability is required to be reported as an expenditure in governmental funds in the year of a lease's inception (i.e., as the acquisition of an asset). The following adjustments are required to convert from the statutory basis to the modified accrual basis of accounting:
    - Any ending encumbrance liability balance related to leases is eliminated and beginning fund balance is increased by the prior year encumbrance liability related to leases.
    - The offsetting changes in the encumbrance liability are recorded as expenditures to recognize the current year impact. If the net change in encumbrance liability decreased during the year, the adjustment results in an increase in expenditures, but if the net change in encumbrance liability increased from the prior year balance, the result is a decrease to expenditures.
  - As indicated above, although leases are not reported on governmental fund financial statements as leased assets or long-term debt, state organizations should record a transaction as though an asset were purchased outright:
    - In the ***initial year*** of the lease, the lessee records both an expenditure and an "other financing source" even though financial resources for the full lease value were not actually received or disbursed. This entry has zero impact on fund balance.

        - The amount initially recorded and reported as the capital outlay is the acquisition cost determined according to the Lease Asset and the Lease Liability section, above.
- Lessor:
    - In financial statements prepared using the current financial resources measurement focus, a lessor should recognize a lease receivable and a deferred inflow of resources to account for a lease. A lessor should measure the deferred inflow of resources at the initial value of the lease receivable (as described above) plus the amount of any payments received at or before the commencement of the lease term that relate to future periods (for example, the final month's rent). A lessor subsequently should recognize the deferred inflow of resources as inflows of resources (for example, revenue), if available, in a systematic and rational manner over the term of the lease.

The State prepares government-wide financial statements in addition to fund financial statements. Government-wide financial statements include governmental and proprietary funds, as well as component units. Governmental fund activity must be adjusted to the accrual basis of accounting for government-wide reporting purposes. Adjustments to the accrual basis are also required for other funds that operate on a statutory basis (certain proprietary and fiduciary funds or component units).

- Lessee:
    - Leases that were initiated in the reporting year and were reported as expenditures in governmental funds under the modified accrual basis of accounting must be reflected as right to use lease assets rather than as expenditures. Related long-term liabilities for the lease liabilities that were reported as other financing sources on the fund level must also be recognized in the same amounts that were initially recognized as right to lease assets.
    - Amortization expense associated with the right to use assets is recognized.
    - Payments made on leases during the year are reported as reductions to lease liabilities rather than as expenditures.
- Lessor:
    - Depreciation expense associated with the right-to-use assets is recognized.

Accrual Basis for Funds Not Reporting on a Statutory Basis - Activity in proprietary and fiduciary funds and component units that do not operate on a statutory basis is reported throughout the year using the full accrual basis of accounting. They report assets acquired under leases as right to use assets and report the related leases in long-term liabilities in their fund financial statements.

- Only in the initial year:
    - The lessee reports the purchase of a right to use asset acquired through a lease as a leased asset, offset by leases payable. The amount initially recorded and reported as a right to use asset should equal the acquisition cost determined according to the Valuation of the Lease Liability and Lease Receivable section, above.
    - The lessor reports a lease receivable and deferred inflow of resources as described in the "Valuation of the Lease Liability and Lease Receivable" section, above.
- The lessee recognizes amortization expense associated with the right to use assets.
- The lessor recognizes depreciation expense associated with the underlying leased asset.
    - A lessor should not derecognize the asset underlying the lease. A lessor should continue to apply other applicable guidance to the underlying asset, including depreciation and impairment. However, if the lease contract requires the lessee to return the asset in its

original or enhanced condition, a lessor should not depreciate the asset during the lease term.

- Interest expense/revenue is recognized throughout the lease term and principal reductions to lease liabilities are recorded as payments are made.

The State has component units in governmental, proprietary, and fiduciary funds. Component unit reporting of leases follows the basis of accounting appropriate for the fund type as described above.

Statement Presentation and Disclosure Requirements

The government-wide financial statements present information about the overall State. All governmental and proprietary (business-type) activities are included, but fiduciary activities are excluded. Component units in the governmental and proprietary funds are either blended in the government-wide financial statements or discretely presented. Component units in fiduciary funds are not reported in the government-wide financial statements.

GAAP requires the following disclosures for lessees:

- General description of its leasing arrangements, including (1) the basis, terms, and conditions on which variable payments not included in the measurement of lease liability are determined and (2) the existence, terms, and conditions of residual value guarantees provided by the lessee not included in the measurement of the lease liability.
- The total amount of lease assets, and the related accumulated amortization, disclosed separately from other capital assets.
- The amount of lease assets by major classes of underlying assets, disclosed separately from other capital assets.
- The amount of outflows of resources (e.g., expense/expenditure) recognized in the reporting period for variable payments not previously included in the measurement of the lease liability.
- The amount of outflows of resources (e.g., expense/expenditure) recognized in the reporting period for other payments (such as residual value guarantees or termination penalties) not previously included in the measurement of the lease liability.
- Principal and interest requirements to maturity, presented separately, for the lease liability for each of the five subsequent fiscal years and in five-year increments thereafter.
- Commitments under leases before the commencement of the lease term.
- The components of any impairment loss associated with the underlying asset, including the amount of impairment loss and any related change in the lease liability.
- Additional disclosures are required for lessees that have sublease, sale-leaseback, and/or lease-leaseback transactions.
- Additionally, the nature and extent of leasing transactions with related parties must be disclosed.

GAAP requires the following disclosures for lessors:

- A general description of its leasing arrangements, including the basis, terms, and conditions on which any variable payments not included in the measurement of the lease receivable are determined.
- The total amount of inflows of resources (for example, lease revenue, interest revenue, and any other lease-related inflows) recognized in the reporting period from leases, if that amount cannot be determined based on the amounts displayed on the face of the financial statements.
- The amount of inflows of resources recognized in the reporting period for variable and other payments not previously included in the measurement of the lease receivable, including inflows of resources related to residual value guarantees and termination penalties.

- Additionally, if a lessor's principal ongoing operations consist of leasing assets to other entities, the government should disclose a schedule of future payments that are included in the measurement of the lease receivable, showing principal and interest separately, for each of the five subsequent fiscal years and in five-year increments thereafter.

Authority:

- Official Code of Georgia Annotated (OCGA) 50-5B-3 – Duties of the state accounting officer include:
  - Prescribing state-wide accounting policies, procedures, and practices.
  - Prescribing the manner in which disbursements shall be made by state government organizations.
  - Developing processes and systems to improve accountability and enhance efficiency for disbursement of funds and management of accounts payable.
  - Determining the proper classification for accounting and reporting purposes of all assets, liabilities, revenues, expenditures, fund balances, funds, and accounts in compliance with legal requirements and generally accepted accounting principles and prescribe a uniform classification of accounts and other accounting identifiers which shall be used by all state organizations.
- O.C.G.A. 50-5B-4(b) – Duties of the state agencies with respect to SAO.
  - All organizations of state government and all officers, agents, and employees thereof shall conform to and comply with the rules, regulations, policies, procedures, and forms devised, promulgated, and installed by the state accounting officer.
- GASB Statement No. 62 – *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989, FASB and AICPA Pronouncements* (Leases section, paragraphs 211–271)
- GASB Statement No. 66 – *Technical Corrections – 2012 – an amendment of GASB Statements No. 10 and No. 62* (paragraphs 24-26)
- GASB Statement No. 87 – *Leases*
- National Council on Governmental Accounting Statement 5 – *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*
- GASB Codification Section L20 – *Leases*
- Georgia Constitution, Article III, Section VI, Paragraph VI – *Gratuities*
- OCGA 12-3-113 – *Duties and powers of department as to system; requirements as to title to land traversed by system* (applies to the Department of Natural Resources)
- OCGA 50-16-7 – *Improvement of real estate held by state in fee simple with reversionary interest in federal government or under long-term federal license*
- SAO Accounting Policy Manual, Capital Assets: *Capital Assets – General*

Applicability:

This accounting policy applies to all organizations included in the State of Georgia reporting entity. The term 'organization of state government' shall mean, without limitation, any agency, authority, department, institution, board, bureau, commission, committee, office, or instrumentality of the State of Georgia. Such term shall not include any entity of local government, including, but not limited to, a county, municipality, consolidated government, board of education, or local authority, or an instrumentality of any such entity. At these reporting organizations, all personnel with accounting and financial reporting responsibilities should be knowledgeable of this policy. Refer to the SAO Accounting Policy – *Management Responsibilities* policy for a summary of general financial reporting responsibilities.

Definitions:

***Cancelable period* –** Periods for which a lessee and lessor both have an option to extend or terminate.

***Contract* –** An agreement (written or verbal) between two or more parties that creates an enforceable right and payable**.**

Contracts That Transfer Ownership – A contract that (a) transfers ownership of the underlying asset to the lessee by the end of the contract and (b) does not contain termination options, but that may contain a fiscal funding or cancellation clause that is not reasonably certain of being exercised, should be reported as a financed purchase of the underlying asset by the lessee or sale of the asset by the lessor.

***Discount Rate* –** For the lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate.

***Exchange or Exchange –Like* –** A transaction in which each party receives and sacrifices something of approximately equal value.

Fiscal Funding or Cancellation Clauses – A provision by which the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the government unit to fulfill its payables under the lease agreement.

***Implicit Rate* –** The rate of interest that at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset and (2) any deferred initial indirect cost of the lessor. However, if the rate determined is less than zero, an implicit rate of zero should be used.

***Incentive* –** This may be a discount or an offer to pay moving costs or make a cash payment to the lessee as a means to induce a lessee to sign a lease.

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.

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.

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

Lease Term – The period in which a lessee has a noncancelable right to use the underlying asset, plus periods covered by lessee or lessor's option to extend the lease (if reasonably certain of being exercised) and periods covered by the lessee or lessor's option to terminate lease (if reasonably certain of being exercised). Note that periods for which both the lessee and the lessor have an option to extend or terminate the lease without permission from the other party are excluded from the lease term.

Lessee – An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in an exchange for consideration.

Lessor – An entity that enters into a contract to provide the right to use an underlying asset for a period of time in an exchange consideration.

Noncancelable Period – The period for which a lease contract is enforceable, and the lease is cancelable only upon the occurrence of some remote contingency.

Nonfinancial Asset – An underlying asset that is not a financial asset as defined in GASB 72. Examples include land, buildings, vehicles, and equipment.

***Nonlease components* -** Lessees and lessors may enter into contracts that contain multiple components, such as a contract that contains both a lease component and a nonlease component. Examples of nonlease components include repairs or maintenance of the leased asset, installation costs, and consumables/supplies.

Reasonably certain – Implies a higher level of certainty. It is much greater to occur that likely to occur.

Related Parties – This term encompasses the following parties and situations:

- A government's related organizations, joint ventures, and jointly governed organizations, as defined in GASB Statement No. 14, *The Financial Reporting Entity*, as amended.
- Elected and appointed officials of the government; its management; members of the immediate families of elected or appointed officials of the government and its management; and other parties with which the government may deal if one party can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- A party that can significantly influence the management or operating policies of the transacting parties (for example, through imposition of will as discussed in Statement 14, as amended) or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Residual Value (RV) of Leased Property – A guarantee made to the lessor that the value of an underlying asset will be at least a specified amount at the end of the lease.

***Right to use* –** the right to obtain the present service capacity from use of the underlying asset and the right to determine the nature and manner of its use.

Short-term leases – Leases that, at the commencement of the lease, have a maximum possible term of 12 months or less, including any options to extend.

***Sublease* –** A transaction in which the underlying asset is re-leased by the lessee (or immediate lessor) to a third party (the sub-lessee) and the original lease between the lessor and the lessee remains in effect.

Underlying Asset – An asset that is the subject of the lease for which a right to use the asset has been conveyed.

Variable payments Based on Index– Payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the commencement of the lease term.

Variable Payments Fixed In-Substance – Payments that are structured as variable lease payments but are in-substance fixed. This is when there are multiple sets of payments that a lessee could make, but it has to make at least one of these. For example, the lessee has to pay $1 per mile for the vehicle lease or a minimum of $500.

Forms and Attachments:

Year-end reporting forms are provided on the SAO website at Year-End Forms | State Accounting Office of Georgia