U.S. Department of
Transportation
Office of the Secretary
of Transportation

ORDER

DOT 1200.8

09-06-2024

Subject: DOT LEASE ACCOUNTING ORDER

1. **PURPOSE:** This volume sets forth the federal accounting principles and the Federal Accounting Standards Advisory Board's (FASAB) standard related to accounting and reporting for certain leases of property, plant, and equipment (PP&E). This Order also documents the Department of Transportation's (DOT) accounting policies related to leases.

2. **CANCELLATION:** This Order does not cancel a previous policy or Order.

3. **APPLICABILITY OF SYSTEMS:** Delphi is the Department's financial system and system of record for all leasing activity. These processes and procedures must remain applicable to all financial systems in use by each DOT Operating Administration (OA) and the Office of the Inspector General (OIG) (hereinafter referred to as an OA). Other systems pertinent to lease procedures affected by this policy include PRISM, Real Estate Management System (REMS), and FAA Real Estate and Asset Management System (FRAMES).

4. **BACKGROUND:** The FASAB approved the Statement of Federal Financial Accounting Standards (SFFAS) 54 for federal leases due to the previous standards having become outdated. DOT and other federal agencies commonly enter into contracts with other parties for the lease of both real and personal property to complete mission objectives. These contracts and agreements, referred to as leases when items of tangible property are involved, typically involve commitments to make and receive payments between the parties involved, and thus represent financial liabilities. FASAB statements centered on SFFAS No. 54 establish the guidance that federal agencies follow for the accounting and reporting of these leases.

   This Order presents the federal accounting and reporting requirements for leases, provides additional explanation and context for parts of this guidance, and memorializes DOT on items requiring standardization of approach or agency interpretation.

5. **REFERENCES:** This Order is issued pursuant to the following provisions of law and regulations.

a. SFFAS Number (No.) 5, *Accounting for Liabilities of the Federal Government, September 30, 1996.*
b. SFFAS No. 6, *Accounting for PP&E, September 30, 1997.*
c. SFFAS No. 10, *Accounting for Internal Use Software, October 9, 1998.*
d. SFFAS No. 47: *Reporting Entity, September 30, 2017.*
e. SFFAS No. 54, *An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government and SFFAS 6. Accounting for Property, Plant, and Equipment, September 30, 2023.*
f. SFFAS No. 58, *Deferral of the Effective Date of SFFAS 54, Leases, June 19, 2020*
g. SFFAS No. 60, *Omnibus Amendments 2021: Leases-Related Topics, For periods beginning after September 30, 2023.*
h. SFFAS No. 61, *Omnibus Amendments 2023: Leases-Related Topics, For periods beginning after September 30, 2023.*
i. SFFAS No. 62, *Transitional Amendment to SFFAS 54, For periods beginning after September 30, 2023.*
j. Financial Accounting Standards Board Technical Bulletin 2023-1, *Intragovernmental Leasehold Reimbursable Work Agreements, For periods beginning after September 30, 2023.*
k. Financial Accounting Standards Board Technical Release No. 20, *Implementation Guidance for Leases, For periods beginning after September 30, 2023.*
l. Financial Accounting Standards Board Technical Release No. 21, *Omnibus Amendments 2022: Conforming Amendments, September 6, 2022.*
m. Financial Accounting Standard Board, Technical Release No. 22, *Leases Implementation Guidance Updates, For periods beginning after September 30, 2023.*
n. Office of Management Budget (OMB) Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control.*
o. OMB Circular A-136, *Financial Reporting Requirements.*

6. **DEFINITIONS:**

a. **Concession:** Rent discount made by the lessor to entice the lessee to sign a lease (e.g., free rent).
b. **Consideration:** Consideration is something of value that is given or promised in exchange for what is conveyed in the contract. It includes all conveyances described as monetary (lease payments) or non-monetary (in-kind services), including all the following payments that will be made during the lease term:

1. Fixed Payments.
2. Variable payments that depend on an index or a rate (such as Consumer Price Index or market interest rate), initially measured using the index rate or rate as of the commencement of the lease term.
3. Variable payments that are fixed in substance. Refer to paragraph 41 of

SFFAS 54.

4. Amounts that are probable of being required to be paid by the lessee under residual value guarantees.
5. The exercise price of a purchase option if it is probable that the lessee will exercise that option.
6. Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) an availability of funds or cancellation clause.
7. Any lease incentives receivables from the lessor. Refer to paragraphs 70-71 of SFFAS 54.
8. Any other payments to the lessor that are probable of being required based on an assessment of all relevant factors.

c. **Current Lease Agreement Date:** The lease agreement date is the date on which a legally binding contract comes into existence. The current lease agreement date is the date of the initial (or) the renewal agreement that is in effect as of the evaluation date.

d. **Current Lease Commencement Date:** Current date on which a lessor makes an underlying asset available for use by a lessee. In practice, the current lease commencement date is also the start date of the lease term. This may be the start of the original noncancellable period, or the start of a renewal period.

e. **Current Lease End Date:** The end date of the current active lease term or that of the renewal and/or termination option if it has been determined it is probable to be exercised.

f. **Discount Rate for the Lease:** When DOT is either a lessee or lessor, the discount rate for the lease is the rate the lessor charges the lessee. If the interest rate is not stated in the lease, the interest rate should be based on the interest rate of marketable Treasury securities at the commencement of the lease term (or at the subsequent financial reporting date) with a similar maturity to the term of the lease.

g. **Escalation:** Terms or conditions included in the contract which dictate that a rent will increase and by how much.

h. **Evergreen Lease:** A lease that automatically renews at the end of the lease term for another series of terms of a determined length, without any action by the parties.

i. **Fixed Payments:** Payments for which amounts are determinable at the inception of the lease regardless of whether the amounts are constant throughout the term of the lease.

j. **Holdover Provision:** Terms or conditions to apply in the case that a lessee remains in the property, or retains possession of good, subsequent to the lease end date.

k. **Incentives:** Lease incentives include lessor payments made to or on behalf of the lessee to entice the lessee to sign a lease.

l. **Initial Direct Lease Costs:** Incremental costs that are directly attributable to negotiating and arranging a lease. These refer to incremental costs of a lease that would not have been incurred if the lease had not been obtained.

m. **Intragovernmental Lease:** An intragovernmental lease is a contract or agreement (often documented in inter-agency agreements (IAAs)) occurring within a consolidated entity or between two or more consolidation entities, whereby one entity (lessor) conveys the right to control the use of PP&E (the underlying asset) to another entity (lessee) for a period of time as specified in the contract or agreement in exchange for consideration.

n. **In-substance Fixed Payments:** Payments that appear to contain variability but are unavoidable per the lease agreement, which makes them fixed in nature.

o. **Lease:** Any written document acting as a contract, agreement, or arrangement between two or more parties that meets the specific criteria established within SFFAS 54: One entity (lessor) conveys the right to control the use of PP&E (the underlying asset) to another entity (lessee) for a period of time as specified in the contract or agreement in exchange for consideration.

p. **Lease Liability:** The lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis. This amount is measured at the lease commencement date as the present value of all future lease payments to be made for the lease term, including options to renew or terminate if the lessee or lessor is probable to exercise the options.

q. **Lease Modification:** A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.

r. **Lease Term:** The base term, or enforceable noncancelable period for which a lessee as the right-to-use an underlying asset, together with all the following:

    1. Periods covered by an option to extend the lease if the lessee is probable to exercise that option;
    2. Periods covered by an option to terminate the lease if the lessee is probable not to exercise that option; and
    3. Periods covered by an option to extend or not, and terminate or not, the lease in which exercise of the options is controlled by the lessor.

s. **Leasehold Improvements:** Additions, alterations, remodeling, renovations, or other changes to a leased property that either extend the useful life of the existing property or enlarge or improve its capacity and are paid for (financed) by the lessee.

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

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

v. **Long-Term Lease:** As used herein, a long-term lease is an SFFAS 54 lease category (labelled simply "lease" within the guidance) for any lease not classified as intragovernmental or short-term (term of 24 months or less & no option to purchase the underlying asset).

w. **Net Lease:** Lessee pays some or all the charges typically incurred as a result of the asset ownership, in addition to its lease payment to the lessor.

x. **Nonlease Components:** Components of a contract which are not related with providing the right-to-use an asset to the lessee and as such do not meet the definition of a lease, such as maintenance services.

y. **Period of Use:** The total period of time that an asset is utilized to fulfill a contract (including the sum of any non-consecutive periods of time).

z. **Probable:** An event is considered probable when its likelihood of occurrence is equal to or greater than 50%.

aa. **Purchase Option:** Terms and conditions which enable the lessee to purchase the leased asset.

bb. **Residual Value Guarantee:** A guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. The part of the residual value that is guaranteed by the lessee or by a party related to the lessee.

cc. **Right-to-Use Lease Asset (RTU Asset):** An asset that represents a lessee's right-to-use an underlying asset for the lease term.

dd. **Short-Term Lease:** A lease that, at commencement date, has a lease term of 24 months or less and does not include an option to purchase the underlying asset that the lessee is probable to exercise.

ee. **Standalone Price:** The price at which a customer would purchase a component of a contract separately.

ff. **Sublease:** A transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) while the original lease between the lessor and the lessee remains in effect.

gg. **Underlying Asset:** An asset that is the subject of a lease for which a right-to-use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset.

hh. **Useful Life of Asset:** The normal operating life in terms of economic utility to the lessee.

ii. **Variable Lease Payments:** Payments made by a lessee to a lessor for the right-to-use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

7. **POLICY:** This Order applies to all Secretarial Offices and DOT OAs per DOT Order 1320.16C, "U.S. Department of Transportation Directives System." Additionally, this order applies to the Office of the Inspector General (OIG) to the extent that the OIG determines it is consistent with the OIG's independent authority under the Inspector General Act and does not conflict with other OIG policies or the OIG mission.

   DOT Assistant Secretary for Budget and Programs and the Chief Financial Officer (CFO) for DOT directs Secretarial Offices and DOT OAs to follow policy and guidance as described in this Order. This Order sets forth the federal accounting principles and FASAB's standard related to accounting and reporting for certain leases of PP&E and documents the DOT's accounting policies related to leases. Secretarial Offices and DOT OAs are responsible for adhering to this Order and that appropriate internal controls are developed to support a well-managed accounting leasing program. Where applicable

OA's may develop supplemental internal lease guidelines that more directly address specific business needs of the OA. The guidelines may be more restrictive but may not be more lenient. An OA-specific guideline shall not conflict with the policy outlined in this document and a copy shall be provided to the Office of Financial Management.

DOT is responsible for the tracking and recording of leases involving PP&E in accordance with generally accepted accounting principles (GAAP), FASAB official pronouncements, and OMB Circular A-123, Management's Responsibility for Enterprise Risk Management and Internal Control. This Order is organized into the sections below:

Section 7.A: Lease Identification
Section 7.B: Requirements to Assess Lease Term & Classify Leases
Section 7.C: Requirements to Determine Treatment of Lease Payments
Section 7.D: Requirements for Intragovernmental Lease Accounting (Lessee & Lessor)
Section 7.E: Requirements for Short-Term Lease Accounting (Lessee & Lessor)
Section 7.F: Requirements for Long-Term Lease Accounting (Lessee)
Section 7.G: Requirements for Long-Term Lease Accounting (Lessor)
Section 7.H: Requirements for Treatment of Contracts with Multiple Lease Components
Section 7.I: Requirements for Modifications & Reassessments
Section 7.J: Requirements Related to Materiality
Section 7.K: Requirements Related to Discount Rates
Section 7.L: Requirements Related to Sub-Leases
Section 7.M: Requirements Related to Presentation & Disclosures (Lessee)

<u>Section 7.A: Lease Identification:</u> This section describes the concepts required to assess whether a contract or agreement meets the definition of a lease as established by SFFAS 54.

a. **Guiding Principles:**
   SFFAS 54 establishes the guidance that Federal agencies follow for the accounting and reporting of leases and associated liabilities. Under SFFAS 54, if any written document acting as a contract, agreement, or arrangement between two or more parties meets specific criteria, it is considered to be a lease. The following sections outline these criteria and provide guidance for the assessment of whether such a document is considered a lease for proprietary accounting purposes.

   See Appendix A of this volume for further information on lease identification.

b. SFFAS 54 Lease Criteria:

For the purposes of applying SFFAS 54, a contract is considered a lease when the following criteria are met:

a) There is a specified underlying asset of PP&E;
b) The lessee has the right to obtain economic benefits or services from the underlying asset;
c) The lessee has the right to control access to the economic benefits or services of the underlying asset;
d) There is a defined period of time in the contractual arrangement;
e) There is an exchange of consideration for right to the underlying asset; and
f) The contract does not fall into a scope exclusion category.

If there are multiple components in a contract, each item of property or service should be independently assessed against these criteria.

c. **Specified Underlying Asset:** To qualify as a lease under SFFAS 54, a contract must specify an underlying asset that is an item of PP&E. An asset can be identified by being explicitly specified in a contract (for example, the address of an office space or the Vehicle Identification Number (VIN) or implicitly specified, such as by identification at the time that the asset is made available for use by the lessee, or by its use in the performance of the contract).

d. Right to Obtain Economic Benefits from Use of the Underlying Asset: To qualify as a lease under SFFAS 54, a contract must give the lessee the right to obtain economic benefits or services from use of the underlying asset as specified in the contract. These economic benefits may be obtained either directly, through possession and use/operation of the asset, or indirectly, by use/operation by the lessor to provide services to, and for the benefit of, lessee. Furthermore, there is no requirement that the contract give the lessee the right to obtain all the economic benefits of the underlying asset. The right to obtain the specific benefits identified in the contract, at the times contractually specified, suffices to meet this criterion. Therefore, neither possession by DOT nor exclusive use by DOT are necessary conditions to meet this requirement.

e. Right to Control Access to the Economic Benefits of the Underlying

f. Asset: To qualify as a lease under SFFAS 54, a contract must give the lessee the ability to exclusively access the economic benefits as described in the contract.

g. Period of Time: To qualify as a lease under SFFAS 54, the contract must specify a period of time during which the contractual arrangement exists, it cannot be perpetual or unspecified. Contracts commonly establish a term during which the contractual relationship exists and then grant termination, renewal, or purchase options to either or both parties. The fact that such contracts initially establish a term suffices to meet the period of time requirement. In contrast, contracts that establish that the contractual relationship exists until either party terminates it do not meet the period of time requirement.

h. **Exchange of Consideration:** To qualify as a lease under SFFAS 54, the contract must contain consideration that is exchanged in return for the right to control the use of the underlying asset. Consideration can be monetary or non-monetary (services or goods provided). DOT does not enter into contracts involving in-kind consideration (non-monetary consideration). Therefore, contracts do not need to be assessed for the presence of non-monetary consideration, and a lease without rental payments can be construed to not meet the SFFAS 54 consideration requirements.

i. **Requirements for Out-of-Scope Leases for SFFAS 54:** The following situations and contracts are explicitly scoped out of SFFAS 54 and should be accounted for in accordance with other applicable accounting standards:

<u>Assets under Construction / Payments before Asset Possession:</u> Leases of assets prior to the commencement of the lease term, such as during construction periods, should not be accounted for under SFFAS 54 until DOT takes possession of the property.

<u>Internal Use Software:</u> Leases (licenses) of internal use software should be accounted for in accordance with SFFAS 10, *Accounting for Internal Use Software*.

<u>Contracts that Transfer Ownership:</u> A contract or agreement that a) transfers ownership of the underlying asset to the lessee by the end of the contract or agreement and b) does not contain options to terminate, but that may contain an availability of funds or cancellation clause that is not probable of being exercised, should be reported as a purchase of that asset by the lessee or as a financed sale of the asset by the lessor.

j. Special Contract Situations:

<u>Holdover Leases:</u> If a lease has expired, but the tenant does not vacate a leased space or relinquish an item of leased equipment, AND the lessee continues to make rent payments that are accepted by the lessor, the lease is considered to be in ‘holdover’. Leases will commonly contain holdover clauses that stipulate,

among other things, the amount of rent that will be paid in such a situation. However, since the lease has expired, there is no contract governing the arrangement.

At any point in time, DOT may be in a holdover situation regarding certain leases in that expiration has passed but DOT continues to occupy the property and pay rent. There may be an intention to ultimately renew the lease or enter into a new lease agreement for the same item of property. However, since there is no current contract governing holdover situations, there is no lease obligation to account for under SFFAS 54. Therefore, DOT treats leases that are in holdover similarly to short-term leases and expenses payments as they are incurred.

Standstill Agreements: A situation related to leases in holdover is that involving standstill agreements. Standstill agreements between a lessor and lessee preserve the status quo when the procurement for an expiring lease cannot be completed before the end of its term and a holdover is imminent. They temporarily maintain a lessee's tenancy and rent payments until an extension or new lease can be executed without offering any guarantee that such will occur. Standstill agreements act as contractual amendments in this way and should be evaluated for any lease accounting implications using the guidance for modifications and reassessments.

Service Contracts with Lease Components (Embedded Leases): As noted above, contracts should be assessed against the SFFAS 54 criteria for a lease at a component level by assessing whether each item of property and/or service being provided under the contract meets all the SFFAS 54 lease criteria. The component-by-component breakdown of the contract determines the primary purpose of the contract – whether the purpose of the contract is primarily attributable to the property, or the services provided. Contracts with a primary purpose attributable to property that meet the SFFAS 54 criteria are deemed leases and accounted for in accordance with the guidance contained within this Order.

For contracts with a primary purpose attributable to services that also contain lease components, those lease components constitute what are termed 'embedded leases.' Current FASAB guidance stipulates that these lease components be accounted for in accordance with SFFAS 54, however, FASAB Transitional Amendment to SFFAS 54 (SFFAS 62) temporarily suspends those requirements until October 1, 2026, at the latest. However, DOT may elect to report embedded leases before fiscal year 2027, beginning October 1, 2024, or October 1, 2025. Once the elected transitional accommodation period has ended, DOT will account for lease components within service contracts in accordance with SFFAS 54 guidance. Therefore, embedded leases do not need to be identified by DOT at this time and will not be accounted for in accordance with the guidance contained within this Order until B30 determines the elected transitional accommodation period for DOT.

Example 1: Identified Asset, Economic Benefits & Control of Access
DOT has an arrangement to lease vehicles from a supplier for a per-vehicle monthly charge. Contract terms and conditions state that DOT has the unilateral right to dictate how the vehicles are used (e.g., when they will be driven and by whom) and for what purpose the vehicles are used (e.g., to support field agent travels). The supplier delivers the vehicles to a DOT field office and has no further involvement with the vehicles except for providing maintenance services and removing the vehicles from the DOT field office at the end of the contract's period of performance. DOT is the sole user of the vehicles throughout the contract term. In this example, the contract contains a lease because:

- Consideration is exchanged;
- A period of time is established during which the contractual relationship exists;
- The vehicles are identified assets which are implicitly specified at the time they are made available to DOT (and perhaps also explicitly specified within the contract documentation); and
- DOT is the only entity using the vehicles during the period of use and as such is the recipient of the economic benefits of the vehicles, and controls access to those economic benefits, throughout the period of use.

Section 7.B: Requirements to Assess Lease Term & Classify Leases: This section outlines the concepts and guidance related to lease term that are involved in lease classification and accounting. The guidance in this section contains definitions and explanations of key lease term concepts, as well as establishes the policy for assessing and determining lease term.

1. **Guiding Principles:** Lease accounting guidance categorizes leases into one of three distinct classifications (long-term, short-term, intragovernmental), each of which is prescribed unique accounting treatment. Identification of the counter party in the lease (whether the lessee or lessor entities qualifies as intragovernmental) and the duration of the lease term are the determinants of lease classification.

2. **Understanding Lease Dates:**

   Lease Agreement Date: In contracting, an agreement date is the date on which a contract is executed (signed by both parties). In many cases, signatures on a contract are accompanied by an indication of the date of signing. Since a contract cannot be considered fully executed until both parties have signed, the most recent date should be taken as the agreement date in cases in which the parties signed on different days. When signatures are not accompanied by an indication of the date of signing, reference can often be made to the contract preamble (often the first page) in which a date of agreement is often mentioned in text. Absent these two items, a contract agreement date may not be definable within the documentation alone.

Lease Commencement Date: While the commencement date of the contract for legal purposes is that stated as the beginning of the lease term, the date on which an underlying asset is first made available to the lessee in a condition that is consistent with how it was described in the contract or how it is expected to be used (the date of possession) is the appropriate commencement date in lease accounting:

a) For real estate contracts**,** the commencement date is that on which DOT has full access to the premises; and
b) For vehicle or equipment leases**,** the commencement date is that on which the asset has been delivered to DOT and is ready for use.

Note: If there is a construction period involved (asset construction, as opposed to installment of leasehold/tenant improvements), DOT does not commence the lease accounting until construction is completed and possession of a ready-to-use asset is obtained.

Example 1: Commencement Date DOT contracts with a third-party lessor for office space where its field representatives will be located. The lease was signed one month before the lessor gives DOT full access to the office space and rent was to be paid once DOT has taken possession. Accordingly, the commencement date of this contract for lease accounting purposes is the day the office space is made available to DOT despite the earlier agreement date.

Example 2: Commencement Date DOT contracts with a third-party lessor for office space where its field representatives will be located. As an incentive to sign the lease, the lessor gives DOT full access to the office space one month before the first day of the stated lease term. Accordingly, the commencement date of this contract for lease accounting purposes is the day the office space is made available to DOT, even though it is one month before the lease term begins for legal purposes.

Lease Expiration Date: The lease expiration date is the end date of the lease term, as adjusted for likely option exercises. If a lease is signed on 1/1/2020 with an expiration of 12/31/2022 and a one-year renewal option, and the renewal option is not likely to be exercised, then the end date is 12/31/2022. If the renewal option is likely to be exercised, then the expiration date is 12/31/2023.

3. Requirements to Assess Lease Term (Lessee):

A first step in accounting for leases is the determination of the *accounting* lease term for a given contract. This step is necessary to determine:

a) The SFFAS 54 classification of the lease (long-term, short-term, or intragovernmental); and
b) The amortization period of the right-to-use asset and lease liability in the event that the lease is classified as a long-term lease.

The *accounting* lease term is the noncancellable period plus certain periods subject to options to extend or terminate the lease. The noncancellable period is the shorter of:

a) The period identified in the lease contract or agreement that precedes any option to extend the lease; or
b) The period identified in the lease contract or agreement that precedes the first option to terminate the lease.

The lease term includes the noncancelable period and the following periods, if applicable:

a) Periods specified in the lease that relate to a lessee's option to extend the lease if it is probable that the lessee will exercise that option;
b) Periods specified in the lease that follow a lessee's option to terminate the lease (up until the point in time when there is another option or, if none, the end of the lease) if it is probable that the lessee will not exercise that option;
c) Periods specified in the lease that relate to a lessor's option to extend the lease if there is significant evidence that the lessor will exercise that option; and
d) Periods specified in the lease that follow a lessor's option to terminate the lease (up until the point in time when there is another option or, if none, the end of the lease) if there is significant evidence that the lessor will not exercise that option.

Based on the above SFFAS 54 guidance, it can be seen that the lease term for accounting purposes is dependent on an assessment of the likelihood of either party exercising any renewal, termination, or purchase options granted within a contract.

4. **Requirements to Determine Lease Term (Lessor):** The lessor's lease term includes the noncancelable period and the following periods, if applicable:
   a) Periods specified in the lease that relate to a lessor's option to extend the lease if it is probable that the lessor will exercise that option;
   b) Periods specified in the lease that follow a lessor's option to terminate the lease (up until the point in time when there is another option or, if none, the end of the lease) if it is probable that the lessor will not exercise that option;

c) Periods specified in the lease that relate to a lessee's option to extend the lease if there is significant evidence that the lessee will exercise that option; and
d) Periods specified in the lease that follow a lessee's option to terminate the lease (up until the point in time when there is another option or, if none, the end of the lease) if there is significant evidence that the lessee will not exercise that option.

5. **Determining Probability of Option Exercise:** FASAB provides definitions of the terms "probable" and "significant evidence" to use in determining the likelihood of exercising an option.

   The FASAB definition of 'probable' equates to "more likely than not," or mathematically a probability of 50% or greater. This definition should be applied when determining whether DOT as a lessee is probable to exercise a lease option. In determining that an option is probable to be exercised, FASAB indicates that a compelling economic reason to exercise the option should exist. As part of assessing for just such a compelling economic reason, lessees and lessors should assess all factors that are relevant to the likelihood of option exercise, including asset-based, market-based, contract-based, or agency-based factors as those categories are established in SFFAS 54.
   Additionally, options should be considered in chronological order. If a determination is made that an additional period will not be added to the lease term for an option based on the likelihood criteria, subsequent options would not be considered.

   The factor categories listed below are those provided by FASAB in delineating the sorts of considerations that should be considered in assessing the likelihood that a party to a lease will exercise a granted option.

Factor Category	Factor	Example
Asset-Based	Asset-based factors are those associated with the physicality of the underlying asset itself (asset location, abandonment of significant leasehold improvements, costs to return an asset in a specified condition, etc.).	Significant investments made in fixtures, equipment, and other leasehold improvements at a leased property may indicate an increased likelihood of renewal or a decreased likelihood of termination.
Market-Based	Market-based factors are those associated with the supply and demand of the market for a leased item (availability and cost of identifying another suitable underlying asset, contract vs. market price for comparable assets, etc.).	The restricted availability of comparable assets within a market may indicate an increased likelihood to exercise available renewal options and a decreased likelihood to exercise any termination options.
Contract-Based	Contract-based factors are those associated with the contracting process itself (economic disincentives to terminate a lease, costs to negotiate a new lease, etc.).	A prohibitively high termination penalty in a particular lease may disincentivize early termination.
Federal-Specific	Federal-specific factors are those associated with an agency's overall mission, contracting practices, and contracting history.	The statutory mandate of DOT's mission and objectives may preclude early termination/require renewal exercise of certain leases to the extent that the mission of the service or oversight of transportation operations provided by the installations would endanger continued oversight.

The leases into which DOT enters often include options to terminate or renew. When it is probable that DOT will exercise these options, the time periods covered by the options are considered in the computation of the lease term.

Lessees should include periods covered by lessor-held renewal options and lessor-held termination options if there is significant evidence that the lessor will exercise renewal options or won't exercise termination options. The possession of significant evidence by a lessee that a lessor will or won't exercise an option is the threshold for including these periods within the lease term.

While such evidence can constitute any information that a lessee may possess related to a lessor's intentions regarding a particular lease, the requirement that such evidence be significant is defined to be a higher threshold than probable, more akin to reasonably certain.

Renewal Options: Renewal options are often negotiated into DOT's contracts to provide a way of continuing the use of the underlying asset for a stated period following the date of contract expiration. For instance, a lessee will typically be granted one, two, or three 5-year renewal options; thus, enabling renewal for a period of up to 15 years. If a contract contains terms and conditions which allow the lessee to renew the lease for another predetermined period and it is probable that DOT will exercise this option, then that renewal period should be included within the determination of lease term.

Perpetual Renewal Options: In certain cases, a contract may grant an indefinite number of renewal options to the lessee that are exercisable after an initial fixed term – that is, the contract may be renewed indefinitely for blocks of time corresponding to the term of each individual renewal option**.**

Termination Options: Contracts may include a termination option (also termed an early termination option) for either lessee or lessor to terminate the agreement prior to the end of the lease term.

Purchase Options*:* Purchase options granted in a lease provide a lessee with the right, but not the obligation, to purchase an underlying asset at some point during the lease term or upon expiration. Such options are distinct from transfers of ownership that are already agreed to, and therefore guaranteed to occur, within a lease agreement.
At the commencement of a lease, a lessee should assess whether it is probable to exercise a granted purchase option. If probable, the period of the lease term following exercise should be removed from the lease term. Also, the right-to-use lease asset should be amortized over the useful life of the underlying asset without regard to the lease term for leases with purchase options assessed to be probable to be exercised.

Evergreen Leases: Evergreen leases are leases that automatically renew at the end of each lease period, for a defined renewal term, without any action by either lessee or lessor (one party would have to notify the other of intention not to renew to prevent this from occurring). Leases commonly renew automatically for terms of one month (a month-to-month lease), one year, two years, or five years, although renewal terms can contractually be of any length.

For lease accounting purposes, evergreen periods are cancellable since either party may terminate the lease, and only noncancellable periods are included in the lease term. The most common type of evergreen lease, a month-to-month renewal, would therefore exclude the portion of the term that comes after the lease enters a month-to-month status. For the less common evergreen leases in which the renewal periods have a period of greater than two years, it is necessary to evaluate whether the lease has already entered into an evergreen renewal. If so, it is possible that some portion of the evergreen term, having already been exercised, is noncancellable. For instance, if one year of a 5-year evergreen period has already passed since automatic exercise, the remaining four years are noncancellable (assuming that both parties DO NOT have termination options) and should be included within the lease term.

<u>Concluding Probability of Exercise:</u> OAs are required to assess the likelihood that any renewal, termination, or purchase options granted in a lease are probable to be exercised or that significant evidence exists that a counter party-held option will be exercised. Likelihood of exercise should be assessed on a lease-by-lease basis with the appropriate management and business stakeholders, to include the contracting officers (COs) with knowledge of a particular lease. Deliberations with COs to assess likelihood of exercise should consider all factors relevant to likelihood of exercise described in the table above, and conclusions should be documented within abstraction materials.

6. **Requirements to Classify Leases**:

Leases that are in-scope for SFFAS 54, are classified into one of three categories:

a) Intragovernmental – An intragovernmental lease occurs within a consolidation entity or between two or more consolidation entities as defined in SFFAS 47;
b) Short-Term – A short-term lease is a non-intragovernmental lease with a lease term of 24 months or fewer at commencement; and
c) Long-Term (simply labelled a “lease” in SFFAS 54) – Any lease not classified as intragovernmental or short-term is a long-term lease.

DOT considers a lease in which the counter party is another federal governmental entity to be an intragovernmental lease since it would constitute a consolidation entity with respect to the Department of Treasury’s Financial Report of the United States Government. Common examples of intragovernmental leases include arrangements between DOT and other federal entities (often documented in IAAs).

For non-intragovernmental leases, the calculation that results from the aforementioned lease term assessment and accounts for both the noncancellable term as well as the likelihood that available options will be exercised, is used to distinguish between short-term and long-term leases.

Lease Term Assessment & Classification Examples:

Example 1 – Short-Term Lease: DOT enters into a 2-year lease for office space in Washington, D.C. The following terms and conditions apply:

- Termination option is granted to lessee that is exercisable at any time after the first year of the lease.
- Option to purchase the office space at the then-prevailing fair value at any time during the lease is granted to lessee.
- DOT determines, at commencement, that it is not probable to exercise either the termination option or the purchase option.

By assessing the base term and both options, a probable lease term of 2 years is determined which causes this to be a short-term lease; a term of 24 months or fewer constitutes a short-term lease classification under SFFAS 54.

Example 2 – Long-Term Lease: DOT enters into a 2-year lease for office space in Oklahoma City, Oklahoma. The following terms and conditions apply:

- Two 5-year renewal options are granted to lessee at the same terms & conditions as the original lease term.
- Termination option is granted to lessee that is exercisable at any time after the first year of the lease.
- Option to purchase the office space at the then-prevailing fair value at any time during the lease is granted to lessee.

At commencement, the DOT lease specialist determines that DOT is probable to exercise the renewal options since the office use is a permanent need and few alternative space options exist in this location. However, due to staffing increases at nearby Mike Monroney Aeronautical Center and the anticipated completion of construction of additional administrative offices at the Center within 8 years, DOT is likely to want to exercise the termination option before completion of the second 5-year term. The probable lease term is therefore determined to be 8 years (2-year original term + 5-year first renewal term + 1 year of the second renewal term), which causes this lease to be classified as a long-term lease.

Section 7.C: Requirements to Determine Treatment of Lease Payments: This section outlines the various types of payments that are made between parties entering into a lease agreement, explains the appropriate accounting treatment for each payment type, and establishes the rules for determining payment amounts.

1. **Guiding Principles:** Once it has been determined that a particular contract constitutes a lease under SFFAS 54 and an accounting lease term has been

determined, it is necessary to identify the payments that must be accounted for in accordance with SFFAS 54.

Note: Not all payments associated with a lease are governed by this standard. Payments not meeting the below criteria are not governed by SFFAS 54.

2. **Lease Payment Characteristics:** Payments made under a lease agreement inherently involve several characteristics that are pertinent to lease accounting:

    a) **Who is the payer and payee?** Although most payments are made by the lessee to the lessor, there are certain payments that are made by the lessor to the lessee such as incentives and tenant improvements.
    b) **What is being purchased?** It is critically important to establish the purpose of each lease payment, because only payments that are made in exchange for the right-to-use the underlying asset are governed by SFFAS 54 lease accounting guidance. The accounting for other types of payments, such as payments for services (building operating costs, for instance), is governed by accounting standards other than SFFAS 54 and should be accounted for separately.
    c) **What is the timing?** The timing of the payments must be appropriately understood to ensure that lease calculations are correct.

3. **Lease Payments Based Upon Variability:**

    <u>Fixed Payments:</u> Payments which are determinable at lease commencement are fixed. This is true even if that payment changes during the term in a manner that is known and determinable at commencement (such as rent payments that escalate each year by amounts known at commencement). Fixed payments made in exchange for the right-to-use the underlying asset are included in the measurement of the lease liability of long-term leases.

    <u>Variable Payments:</u> Certain lease payments made in exchange for the right-to-use the underlying asset that are variable in nature, and ultimately dependent on future calculation, may not be determinable at lease commencement. For instance, payments that are based on future performance of the lessee (percentage rents based on sales) or usage of the underlying asset (vehicle charges based on miles driven). These payments are not included in the lease liability of long-term leases. However, other variable payments are included in the lease liability of long-term leases such as the following:

    a) Variable payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate) are included in the measurement of the lease liability, initially measured using the index or rate as of the commencement of the lease term; and
    b) Any component of a variable payment that is fixed in-substance

should be included in the lease liability. An example is a lease payment based on a percentage of sales or usage but with a required minimum amount to be paid. That required minimum payment is fixed in-substance.

Example 1: In-Substance Fixed Payments
An entity enters into a 5-year lease for building space with a lessor. The initial base rent is $200,000 per month. Rents increase by the greater of a) Consumer Price Index (CPI) or b) a minimum of 3.5% of the previous rental rate, on each anniversary of the lease commencement date.

The lease payments to be accounted for in the lease liability of this long-term lease are the fixed monthly payments of $200,000 plus the minimum annual increase of 3.5% per annum. Lessee is required to pay no less than a 3.5% increase regardless of the level of receipts or activity at the property; therefore, this minimum level of increase is an in-substance fixed lease payment.

4. **Specific Payment Types:**

Initial Direct Lease Costs: Initial direct lease costs are costs that are directly attributable to negotiating and arranging a lease or portfolio of leases that would not have been incurred had DOT not entered into the lease. Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as fixed employee salaries, are not considered to be initial direct lease costs.

Examples of initial direct lease costs for both a lessee and lessor include:

a) Costs associated with drafting and executing a lease, such as attorney fees; and
b) Costs associated with placing the asset into service, such as installation and delivery fees.

The following items are not considered to be initial direct costs:

a) General overheads; and
b) Costs related to activities that occur before the lease is obtained, for example, the costs of obtaining tax or legal advice.

For lessees, initial direct lease costs can be added to the right-to-use lease asset associated with balance sheet recognition of a lease so that they may be amortized during the lease term. However, since these costs necessarily would have been already paid at commencement and are no longer owed, they would not be part of

the lease liability - initial direct costs can be added to the right-to-use lease asset but not the associated lease liability. Initial direct costs should initially be recognized as prepaid assets when incurred and later transferred to the right-to-use lease asset upon lease commencement. For lessors, initial direct lease costs incurred should be reported as an expense of the period.
DOT only includes initial direct lease costs within the right-to-use lease asset if the associated payments are documented within the lease (meaning that the existence and amount of the payment is established within the lease). Costs that constitute initial direct lease costs may be incurred that are paid by DOT to parties other than lessors (such as to contract attorneys for drafting services), and therefore references to them are not found within contract documentation. Such costs are not currently tracked by DOT and will therefore not be included within right-to-use lease assets.

Prepayments: Payments made to lessors before commencement of the lease or at the time of commencement can include payments for a number of items, including advance base rent payments (payments in exchange for the right-to-use the underlying asset) and nonrefundable security deposits.

Such payments should be added to the right-to-use lease asset associated with balance sheet recognition of a lease so that they may be amortized during the lease term. However, since these costs necessarily would have been already paid at commencement and are no longer owed, they would not be part of the lease liability; prepayments can be added to the right-to-use lease asset but not the associated lease liability. Prepayments should initially be recognized as prepaid assets when incurred and later transferred to the right-to-use lease asset upon lease commencement. For lessors, prepayments are included in unearned revenue but not the associated lease receivable.

Security Deposits: Security deposits paid to a lessor are typically of two types: refundable and nonrefundable. DOT accounts for refundable deposits as a security deposit asset upon payment as these amounts may be refunded by lessors. Refundable security deposits should not be included in the right-to-use lease asset or lease liability as it is already accounted for as a security deposit asset and may be recovered at the conclusion of the lease term.

A nonrefundable security deposit is considered an in-substance lease payment for lease accounting purposes, as this payment will not be recaptured by the lessee. Nonrefundable security deposits should be added to the right-to-use lease asset (but not the lease liability if paid before or at commencement) and amortized during the lease term.

Lease Incentives & Concessions: Lease incentives and concessions include payments made by a lessor to or on behalf of the lessee to entice the lessee to sign a lease. These payments have the effect of reducing the amount that a lessee is required to pay for a lease. Common incentives and concessions include:

a) Up-front cash payments to the lessee, such as moving costs, termination fees to lessee's prior lessor, or lessor's assumption of the lessee's lease obligation under a different lease with another lessor;
b) Lease concessions by the lessor to entice the lessee to sign a lease, such as free rent periods or reduced rents;
c) Payments made to or on behalf of the lessee, such as contracting commissions being paid on behalf of DOT; and
d) Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party.

Payments made to the lessee and the estimated loss incurred by the lessor reduce the fixed lease payments for both the lessee and lessor when classifying the lease and measuring the lease liability and right-to-use asset.

Common types of lease incentives are rent abatement, tenant improvement allowances paid directly to the lessee[1], discounted services, discounted/free/deferred rent, the assumption of a lessee's liability by the lessor, and favorable payment terms. When DOT receives lease incentives, the measurement of the lease liability and right-to-use lease asset are both impacted.

Improvements to Leased Property: Improvements made to real property to make it ready for occupancy are commonly termed either 'leasehold improvements' or 'tenant improvements' depending upon whether the ultimate financial responsibility for those improvements lies with the lessee or the lessor.

Leasehold improvements are those for which ultimate financial responsibility lies with the lessee. These are commonly improvements made to a property without any contractual involvement by the lessor (the lease contract may simply refer to a lessee's right to build out the leased property to the desired specifications required for use). In some cases, however, a lessor may initially provide 'financing' for a lessee by incurring those improvement costs and subsequently being reimbursed by lessee. In this case, financial responsibility can be seen to ultimately be borne by the lessee, and it is this ultimate financial responsibility that is of interest.

Tenant improvements (TI) are those for which ultimate financial responsibility lies with the lessor. These are commonly improvements made to a property by a lessor to incentivize a lessee to enter into a lease agreement. Such expenditures are commonly referenced in contract documentation. In some such cases, a lessor will commit to and carry out a list of improvements, without any lessee financial involvement or even knowledge. In other cases, a contract will quantify a TI allowance, to be retained and disbursed by either lessor or lessee, to which spending on improvements will be limited. In each of these cases, ultimate financially responsibility is borne by the lessor.

[1] Lease incentives do not include tenant allowances that are paid directly to the vendor by the lessor.

Property Improvement Scenarios:

Leasehold Improvements
Scenario 1: Leasehold improvements are paid directly by DOT and likely not even mentioned in the contract. Account for these expenditures outside of the SFFAS 54 calculations.
Scenario 2: Leasehold improvements are initially paid for by lessor and then reimbursed to the lessor by DOT. This scenario would likely be agreed to explicitly in the contract. The value of these improvements cannot be construed as incentives under SFFAS 54, because they are paid for by DOT. Account for these expenditures outside of the SFFAS 54 calculations.

Tenant Improvements
Scenario 1: TIs are paid directly by the lessor with lessee having no awareness of the cost of such improvements. The value of these improvements, which could be construed as incentives under SFFAS 54, may be accounted for within the SFFAS 54 calculations if an OA's accounting policy prescribes recording an asset for such items and the useful life of the improvements coincides with the lease term.
Scenario 2: TIs are paid directly by the lessor. A TI allowance is quantified within the contract, however the balance is retained and disbursed by the lessor. The value of these improvements, which could be construed as incentives under SFFAS 54, may be accounted for within the SFFAS 54 calculations if an OA's accounting policy prescribes recording an asset for such items and the useful life of the improvements coincides with the lease term.
Scenario 3: TIs are paid directly by DOT using a TI allowance quantified within the contract and retained by DOT. The value of this allowance needs to be accounted for as an incentive within the SFFAS 54 calculations because 1) it reduces the amount that DOT is required to pay for the lease and 2) DOT accounting policy would record the receipt of cash. (Note: The lease accounting policy outlined here assumes proper authority to receive vendor payment exists. All applicable regulations and policies regarding vendor interactions should be followed.)

Overall: Each of the scenarios outlined above requires an assessment of existing OA accounting policy on topics beyond the lease accounting covered in this Order – for example, with regard to the capitalization of leasehold improvements made by DOT and the recognition of TIs received by DOT. OAs are required to confer with the appropriate accounting and budget stakeholders to determine related accounting policy and make the appropriate determination for treatment of lease payments utilizing these scenarios.

Asset Restoration Obligation: Asset restoration obligations (ARO) are commitments by a lessee to restore a leased asset to its original condition upon expiration of a lease. The commitments are commonly established within a lease contract by way of specification of the restoration performance or financial obligations of the lessee. Instead of placing the performance of restoration activities on the lessee (to perform itself or contract with a third-party vendor to perform), some leases allow the lessee to make a payment to the lessor to cover the cost of the restoration activities.

At lease commencement, DOT will assess the likelihood that an ARO would result in an end-of-term expenditure and whether that expenditure would be made to an outside vendor or the lessor. If an ARO expenditure is likely to be incurred and that payment is likely to be made to the lessor, an estimate of that payment should be included within the lease liability and right-to-use lease asset upon commencement, as these would constitute lease payments for accounting purposes.

DOT contracts can contain ARO provisions granting payment options allowing either DOT performance of restoration activities or payment to lessor. Only in the case that payment to lessor is likely will these costs be included within the lease liability and right-to-use asset for this lease. If payment options exist, OAs are required to confer with the appropriate management and contracting stakeholders to determine how payment is likely to be made.

If a lease requires payment of an ARO to the lessor, this situation should be brought to the attention of OST-B30 for estimation of the amount expected to be incurred upon lease expiration.

5. **Residual Value Guarantees (RVGs):** An RVG is a contractual promise made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. A liability exists for DOT as a lessee when the residual value guaranteed to the lessor is greater than what DOT expects the value of the asset will be upon termination of the contract.

   At commencement of a lease, DOT determines if the value of an RVG is greater than the expected value of the leased asset upon contract termination. If DOT determines that it will owe consideration to the lessor upon termination of the contract to cover the RVG, DOT shall include the cost in the calculation of the lease liability and right-to-use asset.

6. **Purchase Option Price:** The cost of purchase options, which are probable to be exercised at the commencement date of the lease, are included in the calculation of the lease payments.

   <u>Early Termination Payment:</u> Leases that include an option to terminate the lease prior to its completion may have an associated penalty or fee. Payments related to early termination options are included in the lease payments if DOT is probable to exercise the option. If at some point during the lease term DOT determines that it is probable it will exercise the early termination option, DOT must recalculate the

amount of the lease liability and right-to-use asset to reflect the impact of the early termination option inclusive of the early termination payment.

Payments during Likely Renewal Periods: As a result of the inclusion of periods of time covered by likely renewal option exercises within the lease term, it is necessary to discern payments likely to be required during future option periods to account for these payments within the lease liability and right-to-use lease asset at commencement. This inclusion is mandated by SFFAS 54, which requires any probable payments to the lessor to be included in the lease liability.

Contractual clauses granting renewal option rights to one or both parties to a contract will often not quantify the amount of rent to be paid during the renewal period. These clauses commonly reference "market rates" and require parties to agree on a new rate prior to the renewal term. When this occurs, DOT will utilize the most recent level of rental payments in the period just prior to the likely to be exercised renewal period as the assumption for renewal payments. The basis for this estimation is that positive rent price inflation is likely, and the previous rental amount will not be reduced in future periods.

Section 7.D: Requirements for Intragovernmental Lease Accounting (Lessee & Lessor): This section provides an overview of the general ledger accounting for intragovernmental leases.

1. **Guiding Principles:** The obligation entailed in entering into an intragovernmental lease does not receive balance sheet recognition under SFFAS 54. Instead, the associated payments are generally treated as period expenses.

2. **Intragovernmental Accounting:** A lessee should recognize lease payments, including lease-related operating costs (for example, maintenance, utilities, taxes, etc.) paid to the lessor, as expenses based on the payment provisions of the lease agreement and standards regarding recognition of accounts payable and other related amounts. Prepaid rent or a payable for rent due should be recognized as an asset or liability, respectively, and an expense should be recognized in the appropriate reporting period based on the specifics of the lease provisions.

   A lessor should recognize lease receipts, including lease-related operating costs (for example, maintenance, utilities, taxes, etc.) received from the lessee as income based on the provisions of the contract and standards regarding recognition of accounts receivable and other related amounts. Rent paid in advance, or a receivable should be recognized as a liability or asset, respectively, and income should be recognized in the appropriate reporting period based on the specifics of the lease provisions.

Rental increases, rental decreases, lease incentives, and lease concessions should be recognized by the lessee when incurred as increases/reductions to lease rental expense.

Leasehold improvements that are placed in service at or after the beginning of the lease term should be amortized over the useful life (the normal operating life in terms of utility to the lessee) of the leasehold improvement, but no longer than the expected lease term.
Initial direct lease costs incurred by the lessee should be expensed when incurred.

Section 7.E: Requirements for Short-Term Lease Accounting (Lessee & Lessor): This section provides an overview of the general ledger for short-term leases.

1. **Guiding Principles:** The obligation entailed in entering into a short-term lease does not receive balance sheet recognition under SFFAS 54. Instead, the associated payments are generally treated as period expenses.

2. **Short-Term Lease Accounting:** A lessee should recognize short-term lease payments as an expense based on the payment provisions of the lease agreement and standards regarding recognition of accounts payable and other related amounts. This means that generally expenses should be recognized as payments are made. However, the basic tenets of accrual accounting still apply: a lessee should recognize an asset if payments are made in advance of the reporting period to which they relate or a liability for rent due and unpaid at the end of the reporting period to which they relate. Rental increases, rental decreases, lease incentives, and lease concessions should be recognized when incurred as increases/reductions to lease rental expense.

   A lessor should recognize short-term lease payments as revenue based on the payment provisions of the lease agreement and standards regarding recognition of accounts receivable and other related amounts. This means that generally revenue should be recognized as payments are made. However, the basic tenets of accrual accounting still apply: a lessor should recognize a liability if payments are made in advance of the reporting period to which they relate or an asset for rent due and uncollected at the end of the reporting period to which they relate. Rental increases, rental decreases, lease incentives, and lease concessions should be recognized when incurred as increases/reductions to lease rental income.

Section 7.F: Requirements for Long-Term Lease Accounting (Lessee): This section provides an overview of the general ledger accounting for lessee positions in long-term leases.

1. **Guiding Principles:** In order to enable the balance sheet to inform users about the obligations and resources used to fulfill an entity's programs and activities, the new lease accounting guidance under SFFAS 54 requires

recognition of liabilities and receivables associated with leases in the balance sheet accounts.

Using the derived lease term and identification of relevant future payments, the lease accounting guidance instructs that lessees recognize a lease liability and a right-to-use lease asset at lease commencement. Initial measurement of the liability and lease asset involves application of the rules regarding which payments to include in the calculation of the liability and lease asset balance. Subsequent measurement involves amortizing the discount on the liability and the right-to-use lease asset.

2. **Initial Measurement:** At the commencement of the lease term, a lessee should recognize a lease liability and an offsetting right-to-use lease asset calculated using the guidance below.

   Lease Liability: A lessee initially should measure the lease liability at the present value of payments expected to be made during the lease term and should include the following:

Add/Subtract	Lease Payment Types
Add	Fixed payments
Add	Variable payments that depend on an index or rate, initially measured using the index or rate as of the commencement of the lease term
Add	Variable payments that are fixed in-substance
Add	Amounts probable to be paid by the lessee under residual value guarantees
Subtract	Lease incentives receivable from lessor
Add	Exercise price of purchase option if probable to be exercised
Add	Payments for penalties for terminating the lease if term reflects the lessee exercising 1) an option to terminate or 2) an availability of funds or cancellation clause
Add	Any other payments to the lessor probable of being required based on all relevant factors

   Variable payments based on future performance of lessee or usage of the underlying asset should not be included in the lease liability, unless there is a portion of the payment that is fixed in-substance, in which case only the fixed in-substance portion should be included. Instead, non-fixed portions of payments should be recognized as an expense in the reporting period in which those payments are incurred.

Relevant future lease payments should be discounted using the interest rate the lessor charges the lessee. If the interest rate is not stated in the lease, rates on Treasury securities should be used (see section 7.K Requirements Related to Discount Rates).

Right-to-Use Lease Asset (RTU): A lessee should initially measure the lease asset as the sum of the following:

Add/Subtract	Initial RTU Component
Add	Amount of the initial measurement of the lease liability
Add	Lease payments made to the lessor at or before the commencement of the lease term
Add	Initial direct lease costs necessary to place the lease asset into service
Subtract	Lease incentives received from the lessor at or before commencement of the lease term

Example 1: Initial Measurement of a Long-Term Lease
DOT enters a 10-year lease for office space with a commencement date of 10/01/2024 (after the SFFAS 54 transition date). Lease payments are $50,000 per year, all payable at the end of each fiscal year, and DOT determined that the appropriate discount rate for this lease is 3%. Furthermore, DOT incurred initial direct lease costs of $15,000. The following liability and asset would be recorded at commencement on 10/01/2024:
Lease liability calculation – At the commencement date, the lease liability is the present value of the 10 future payments of $50,000, discounted at 3%.

Lease liability at 10/01/2024 = $426,510

RTU asset calculation – At the commencement date, the RTU asset is measured as the lease liability of $426,510 plus the initial direct costs of $15,000.

RTU asset at 10/01/2024 = $441,510

Note: Refer to the Treasury Financial Manual and Treasury-provided scenarios for appropriate posting entries.

3. **Subsequent Measurement:** In subsequent financial reporting periods following lease commencement, a lessee should recognize the lease liability, RTU asset, and associated expenses as follows:

Lease Liability: The lease liability is measured as the lease liability plus interest accrued and minus lease payments made. Any payments made should be allocated first to the accrued interest liability and then to the lease liability. The accrual of interest is based on the discount rate of the lease.

RTU Lease Asset: RTU lease assets are measured at cost less any accumulated amortization.

Expense: There are two expense items associated with accounting for leases after initial recognition:

a) Interest Expense: In subsequent periods following commencement, the lessee should calculate the amortization of the discount on the lease liability and recognize that amount as interest expense for the period. Any payments made should be allocated first to the accrued interest liability and then to the lease liability; and

b) RTU Lease Asset Amortization: A lease asset should be amortized in a systematic and rational manner (generally straight-line) over the shorter of the lease term or the useful life of the underlying asset. The amortization of the lease asset should be reported as amortization expense.

   RTU lease asset amortization will occur over the lease term on the assumption that lease terms and the useful lives of underlying assets are equal.

   Note: If the lease transfers ownership of the underlying asset to the lessee or the lessee is probable to exercise an option to purchase the underlying asset, the lessee should amortize the right-to-use lease asset to the end of the useful life of the underlying asset without regard to the lease term.

Example 2: Subsequent Measurement of a Long-Term Lease
DOT enters a 10-year lease of office space with a commencement date of 10/01/2024 (after the SFFAS 54 transition date). Lease payments are $50,000 per year, all payable at the end of each fiscal year, and DOT determined that the appropriate discount rate for this lease is 3%. Furthermore, DOT incurred initial direct lease costs of $15,000.

As described above, a lease liability of $426,510 and RTU asset of $441,510 were recorded at commencement on 10/01/2024. The following amounts would be recorded for activity during the year:

Lease liability calculation at 9/30/2025 – The lease liability upon commencement increased for the accrual of interest and decreased for the year-one payment.

Lease liability at 10/01/2024	*$426,510*
*Interest accrued ($426,510 * 3%)*	*$12,795*
Year-one payment	*($50,000)*
Lease liability at 9/30/2025	*$389,305*

RTU lease asset calculation – The commencement RTU asset would be amortized for one year.

RTU asset at 10/01/2024	*$441,510*
Amortization ($441,510 /10)	*($44,151)*
RTU asset at 9/30/2025	*$397,359*

Note: Refer to the Treasury Financial Manual and Treasury-provided scenarios for appropriate posting entries.

Section 7.G: Requirements for Long-Term Lease Accounting (Lessor): This section provides an overview of the general ledger accounting for lessor positions in long-term leases.

1. **Guiding Principles:** In order to enable the balance sheet to inform users about the obligations and resources used to fulfill an entity's programs and activities, the new lease accounting guidance under SFFAS 54 requires recognition of liabilities and receivables associated with leases in the balance sheet accounts.

   Using the derived lease term and identification of relevant future payments, the lease accounting guidance instructs that lessors recognize a lease receivable and an unearned revenue at lease commencement. Initial measurement of the receivable and unearned revenue involves application of the rules regarding which payments to include in the calculation of the receivable and unearned revenue balance. Subsequent measurement involves amortizing the discount on the receivable and the amortizing the unearned revenue.

2. **Initial Measurement:**
Lease Receivable: A lessor initially should measure the lease receivable at the present value of payments to be received for the lease term, reduced by any provision for uncollectible amounts. Measurement of the lease receivable should include the following types of payments:

Add/Subtract	Lease Payment Types
Add	Fixed payments
Add	Variable payments that depend on an index or rate, initially measured using the index or rate as of the commencement of the lease term
Add	Variable lease payments that are fixed in-substance
Add	Residual value guarantees that are fixed in-substance
Subtract	Lease incentives payable to the lessee

Variable payments based on future performance of lessee or usage of the underlying asset should not be included in the measurement of the lease receivable. Rather, those payments should be recognized as revenue in the reporting period to which those payments relate. However, any component of those variable payments that is fixed in-substance should be included in the lease receivable.

Amounts to be received under residual value guarantees (that are not fixed in-substance) should be recognized as a receivable and revenue when (a) a guaranteed payment is required (as agreed to by the lessee and lessor) and (b) the amount can be reasonably estimated. Amounts to be received for the exercise price of a purchase option or penalty for lease termination should be recognized as a receivable and revenue when those options are exercised.
Relevant future lease payments should be discounted using the interest rate the lessor charges the lessee. If the interest rate is not stated in the lease, rates on Treasury securities should be used.

Unearned Revenue: A lessor should initially measure the unearned revenue as the sum of the following:

Add/Subtract	Initial Unearned Revenue
Add	Amount of the initial measurement of the lease receivable
Add	Lease payments received from the lessee at or before the commencement of the lease term that relate to future periods
Subtract	Lease incentives paid to, or on behalf of, the lessee at or before commencement of the lease term

Example 1: Initial Measurement of a Long-Term Lease
DOT enters a 10-year lease of space in the lessor position with a non-

governmental entity. The commencement date of the lease is 10/01/2024 (after the SFFAS 54 transition date). Lease payments are $50,000 per year, all payable at the end of each year, and DOT determined that the appropriate discount rate for this lease is 3%. Furthermore, on the morning of commencement, DOT paid incentives of $15,000 to the lessee to cover early termination costs at lessee's prior space. The following receivable and unearned revenue would be recorded at commencement on 10/01/2024:

Lease receivable calculation – At the commencement date, the lease receivable is the present value of the 10 future payments of $50,000, discounted at 3%.

Lease receivable at 10/01/2024 = $426,510

Unearned revenue calculation – At the commencement date, the unearned revenue is measured as the lease receivable of $426,510 less the lease incentives of $15,000.

Unearned revenue at 10/01/2024 = $411,510

Note: Refer to the Treasury Financial Manual and Treasury-provided scenarios for appropriate posting entries.

<u>Subsequent Measurement:</u> In subsequent financial reporting periods following lease commencement, a lessor should recognize the lease receivable, unearned revenue, and associated income as follows:

<u>Lease Receivable:</u> The lease receivable is measured as the lease receivable plus interest accrued and minus lease payments received. Any payments made should be allocated first to the accrued interest receivable and then to the lease receivable. The accrual of interest is based on the discount rate of the lease.

<u>Unearned Revenue:</u> Unearned revenue is measured at cost less any accumulated amortization. Unearned revenue is amortized and recognized as earned revenue from the commencement date to the end of the lease term.

<u>Revenue:</u> There are two revenue items associated with accounting for leases after initial recognition:

a) Interest Revenue: In subsequent periods following commencement, the lessor should calculate the amortization of the discount on the lease receivable and recognize that amount as interest revenue for the period. Any payments received should be allocated first to the accrued interest receivable and then to the lease receivable; and

b) Unearned Revenue Amortization: Unearned revenue should be amortized, recognized as earned revenue, in a systematic and rational manner (generally straight-line) over the term of the lease. Variable lease payments which were not included in the computation of the unearned revenue are recognized as revenue as received.

Example 2: Subsequent Measurement of a Long-Term Lease
DOT enters a 10-year lease as a lessor of space owned by the agency with a commencement date of 10/01/2024 (after the SFFAS 54 transition date). Lease payments received are $50,000 per year, all receivable at the end of each year, and DOT determined that the appropriate discount rate for this lease is 3%. Furthermore, on the morning of commencement, DOT paid incentives of $15,000 to the lessee to cover early termination costs at lessee's prior space.

As described above, a lease receivable of $426,510 and RTU asset of $411,510 were recorded at commencement on 10/01/2024. The following amounts would be recorded for activity during the year.

Lease receivable calculation at 9/30/2025 – The lease receivable upon commencement increased for the accrual of interest and decreased for the year-one payment.

Lease receivable at 10/01/2024	*$426,510*
*Interest accrued ($426,510 * 3%)*	*$12,795*
Year-one payment	*($50,000)*
Lease receivable at 9/30/2025	*$389,305*

Unearned revenue calculation – The commencement unearned revenue would be amortized for one year.

Unearned revenue at 10/01/2024	*$411,510*
Amortization ($411,510 /10)	*($41,151)*
Unearned revenue at 9/30/2025	*$370,359*

Note: Refer to the Treasury Financial Manual and Treasury-provided scenarios for appropriate posting entries.

Section 7.H: Requirements for Treatment of Contracts with Multiple Lease Components: Contracts may contain multiple distinct assets or services (with or without itemized pricing) that are to be conveyed by one party to the other. These various contract items can be classified as either 'lease components' or 'nonlease components.' Lease components consist of the right-to-use an asset, while nonlease components are items other than rights to an asset (typically services to be provided to the lessee, but potentially goods to be provided as well). Common nonlease components within contracts include:

1) Common area maintenance services;
2) Equipment maintenance services;
3) Cleaning and janitorial services;
4) Driving and delivery services; and
5) Costs to be incurred by a lessor and reimbursed by lessee, such as insurance and property taxes.

SFFAS 54 requires that components within contractual documents be accounted for separately. Similarly, if a lease involves multiple underlying assets AND the assets have different lease terms, the lessor and lessee should account for each underlying asset as a separate lease component. The following hierarchy should be used to determine component costs:

1) Step 1: Use prices for individual components that are included in the contract, as long as the price allocation does not appear to be unreasonable utilizing observable information (for example readily available standalone prices from other DOT contracts or market research);
2) Step 2: If the contract does not include prices for individual components or if any of those prices appear to be unreasonable, use professional judgement to determine the best estimate for allocating the contract price to components (maximizing the use of observable information from other DOT contracts or market research);
3) Step 3: If not practicable to determine a best estimate for price allocation for some or all of the components, the contract should be accounted for as a single lease unit; and
4) Step 4: OAs are required to perform these steps when allocating contract consideration to lease and nonlease components. If necessary, the appropriate management and contracting stakeholders with knowledge of the contract and pricing should be consulted with. Conclusions should be documented within abstraction materials.

Note: Only the accounting for lease components (payments made in exchange for the right to an underlying asset) is governed by SFFAS 54. Payments for nonlease components are governed by other accounting standards. However, any lease components contained within a contract with a primary purpose attributable to services are considered embedded leases and are not to be accounted for under SFFAS 54 until October 1, 2026, at the latest (see Section A, Service Contracts with Lease Components (Embedded Leases), for further information).

Example 1: Separating Lease and Nonlease Components in Contract with Primary Purpose Attributable to Assets
DOT leases a facility and pays the lessor/landlord for operating expenses (utilities, cleaning, repairs & maintenance, property insurance, etc.) incurred in operating the property. The lease includes a

building as well as equipment that is highly specialized and custom designed for use within the space.

DOT pays the landlord $10,000 per month in rent, $2,500 per month to reimburse insurance premiums, and $5,000 per month for the other operating expenses.

The $10,000 payment for building and equipment is a lease component in that it is consideration paid by DOT in exchange for the right-to-use those items of real and personal property. Since the lease term for both the building and equipment is the same, the building and equipment do not need to be accounted for separately and the $10,000 payment does not need to be allocated partly to the building and partly to the equipment.

The $2,500 payment for insurance is a nonlease component in that it is consideration paid by DOT in exchange for a service from the insurance provider (protection from financial loss) rather than the right-to-use an asset. Similarly, the $5,000 payment for other operating expenses is also a nonlease component paid by DOT in exchange for services provided by the landlord to operate the building.

The $2,500 and the $5,000 nonlease components should be accounted for separately from the lease component payment of $10,000. In this case, that would entail accounting for the $7,500 per month under FASAB accounting standards other than SFFAS 54 and would recognize period expenses for this amount. The $10,000 lease component, however, should be accounted for under the SFFAS 54 standard, and if the lease is a long-term lease, included within the calculation of the right-to-use lease asset and lease liability.

<u>Section 7.I: Requirements for Modifications & Reassessments:</u> This section provides an overview of the contractual and non-contractual events that can necessitate a revision of lease accounting calculations for long-term leases.

1. **Guiding Principles:** Lease records and calculations require maintenance when certain types of events occur. These include contractual amendments entered into by both parties to a lease, as well as events of which only one party may be aware, such as a change in likelihood of option exercise, a revision to payment estimates, or the resolution of a contingency.

2. **Accounting Treatment of Contractual Events:** Lease agreements are commonly amended by agreement between the parties while the contract is in effect. Examples of amendments include changing the lease price, lengthening, or shortening the lease term, and adding or removing an underlying asset (exercising an already-granted option, however, is not

considered to constitute a contractual amendment). DOT leases are also commonly modified to add, remove, or change payees (lessors) under a given lease.

When such contractual amendments are entered into by the parties to a lease, it may be necessary to reperform the lease accounting calculations. If any of the variables used to determine lease term or payments during the lease term are changed by an amendment, the calculations must be reperformed.
SFFAS 54 classifies possible amendment events for lease accounting purposes into two categories:

Partial or Full Terminations: If the lessee's or lessor's right-to-use the underlying asset decreases as a result of the contractual amendment (for example, the lease term is shortened or the number of underlying assets is reduced), that amendment should be accounted for as a partial or full termination under SFFAS 54 guidance. The lessee generally should account for the partial or full lease termination by reducing the carrying values of the lease asset and lease liability (remeasuring the asset and liability) and recognizing a gain or loss for the difference. However, if the lease is terminated as a result of the lessee purchasing the underlying asset from the lessor, the lease asset should be reclassified to the appropriate class of owned asset. A lessor should account for the full or partial termination of a lease by reducing the carrying values of the lease receivable and related unearned revenue (remeasuring the receivable and unearned revenue) and recognizing a gain or loss for the difference. However, if the lease is terminated as a result of the lessee purchasing an underlying asset from the lessor, the carrying value of the underlying asset also should be derecognized and included in the calculation of any resulting gain or loss. Partial terminations may result in the need to also reassess the lease term and lease classification if the noncancellable period of the lease term is changed.

3. **Modifications**: If a contractual amendment does not qualify as a partial or full termination, it should be accounted for as a modification under SFFAS 54 guidance. Lessees and lessors should account for a modification as a separate lease (that is, separate from the most recent lease agreement) if both of the following conditions are met:

    1) The modification gives the lessee an additional lease asset by adding one or more underlying assets that were not included in the original lease; and
    2) The increase in lease payments for the additional lease asset does not appear to be unreasonable based on (1) the term of the amended lease agreement and (2) professional judgement, maximizing the use of observable information (for example, using readily available observable standalone prices).

Unless a modification is reported as a separate lease, a lessee should account for a lease modification by remeasuring the lease liability. The lease asset should be adjusted by the difference between the remeasured liability and the liability immediately before the lease modification. However, if the change reduces the carrying value of the lease asset to zero, any remaining amount should be reported in the statement of net cost as a gain.

Unless a modification is reported as a separate lease, a lessor should account for a lease modification by remeasuring the lease receivable. The unearned revenue should be adjusted by the difference between the remeasured receivable and the receivable immediately before the lease modification. However, to the extent the change relates to payments for the current period, the change should be recognized as revenue or expense for the current period.

Modifications may result in the need to also reassess the lease term and lease classification if the noncancellable period (or options) of the lease term is changed.

4. **Accounting Treatment of Non-Contractual Events:** It may be necessary to update lease accounting calculations and balances even in the absence of a contractual modification if any of the following occur:

<u>Lease Term Reassessment without Contractual Amendment:</u> The assessed lease term may require updating if any of the following occur. In these situations, the lease term should be reassessed even in the absence of a contractual amendment and the balance sheet accounts should be recalculated:

1) The lessor or lessee elects to exercise an option that was previously presumed would not be exercised (was assessed to be not likely to be exercised). Note: This requirement refers to an actual exercise; there is no requirement to reperform calculations for a change in likelihood of exercise.
2) The lessor or lessee does not elect to exercise an option that was previously presumed would be exercised (was previously assessed to be likely to be exercised). Note: This requirement refers to actually not exercising – the date to exercise has passed; there is no requirement to reperform calculations for a change in likelihood of exercise.
3) An event specified in the lease contract or agreement that requires an extension or termination of the lease takes place.

<u>Remeasurement of Lease Liability or Lease Receivable without Contractual Amendment:</u> Even if the lease term does not change, it may be necessary to update lease accounting calculations and balances if any of the following occur. In these situations, the lease liability or receivable should be remeasured even in the absence of a contractual amendment.

1) An assessment of all relevant factors indicates that the likelihood of a

residual value guarantee being required to be paid has changed from probable to not probable or vice versa;

2) An assessment of all relevant factors indicates that the likelihood of a purchase option being exercised has changed from probable to not probable, or vice versa;
3) There is a change in the estimated amounts for payments already included in the liability;
4) There is a change in the interest rate the lessor charges the lessee if used as the initial discount rate; and
5) A contingency, upon which some or all of the variable payments that will be made over the remainder of the lease term are based, is resolved such that those payments now meet the criteria for measuring the lease liability.

The below table summarizes the contractual and non-contractual events that can necessitate a revision of the lease accounting calculations for long-term leases:

Contractual or Non-Contractual	SFFAS 54 Type of Event	Event Description
Contractual Amendment Executed by Parties to Lease	Partial or Full Termination	Term reduction
		Underlying assets reduction
	Modification	Anything that does not contain a term reduction and/or underlying assets reduction
Non-Contractual Event Occurred that Requires Lease Calculations Update	Term Reassessment	Option is exercised that was presumed would not be exercised
		Option not exercised that was presumed would be exercised
		Event takes place that requires an extension or termination of the lease
	Lease Liability/Lease Receivable Remeasurement	Likelihood of a residual value guarantee changed from probable to not probable or vice versa
		Likelihood of a purchase option being exercised changed from probable to not probable or vice versa
		Change in estimated amounts for payments already included in the liability
		Change in the interest rate the lessor charges the lessee
		A contingency is resolved that causes contingent variable payments to become fixed

Section 7.J: Requirements Related to Materiality: Accounting for leases, following the guidance established in SFFAS 54, does not need to be applied to immaterial items. Materiality is determined by the OST Office of Financial Management (B30). Given the low number of leases identified within DOT's transition population, no materiality threshold has been established for DOT OAs (excluding the Federal Aviation Administration (FAA)). All leases should be assessed and accounted for in accordance with the guidance in this Order.

This materiality determination is monitored and assessed via separately performed procedures and is subject to change.

Section 7.K: Requirements Related to Discount Rates: Leases that are classified as long-term under SFFAS 54 are recognized on the balance sheet by recording:

1. By the lessee: a lease liability for the present value of future payments and a right-to-use lease asset to represent the benefit derived from having entered into that contractual commitment.

2. By the lessor: with a lease receivable for the present value of future receipts and an offsetting unearned revenue liability to account for the unearned nature of the receivable; and

3. Balance sheet recognition by both lessee and lessor therefore requires a discount rate by which the future payments/receipts are to be discounted to present value. Guidance for both lessees and lessors are equivalent in SFFAS 54: *"[Future] lease payments should be discounted using the interest rate the lessor charges the lessee. If the interest rate is not stated in the lease, the interest rate should be based on the interest rate on marketable Treasury securities at the commencement of the lease term (or at the subsequent financial reporting date…), with a similar maturity to the term of the lease."*

   As such, there is no requirement to attempt to calculate the interest rate implicit in the lease – if no rate is explicitly stated, the next step is to use the rates on Treasury securities. SFFAS 54 guidance is the following:

   Rates should be based on (consistent with) the interest rate on marketable Treasury securities at the commencement of the lease term (or at the subsequent financial reporting date for remeasurements of the lease liability/lease receivable), with a similar maturity to the term of the lease (SFFAS 61 Para. 42). A rate may be selected based on a recent interest rate on marketable Treasury securities or historical average interest rate on securities of a similar maturity to the term of the lease, provided that the rate is consistent with the rate on such securities at the commencement of the lease term.

DOT utilizes interest rates achieved on notes and bonds auctioned by the Department of Treasury using the rates for notes with maturities of 2, 3, 7, and 10 years and bonds with maturities of 20 and 30 years.

When selecting the rates, SFFAS 61 allows for reporting entities to round up or down to the nearest maturity or interpolate the interest rate for the period between two maturities. Either way the approach a reporting entity chooses needs to be done consistently from period to period.

In order to align the terms of leases with the available maturities on Treasury securities for the purpose of selecting the discount rate appropriate for each lease calculation, DOT rounds lease terms down to the nearest Treasury maturity and does not interpolate between rates. For a contract period greater than 30 years, DOT utilizes the 30-year rate without extrapolation.

Section 7.L: Requirements Related to Sub-Leases: Sub-leases are treated the same as original lease agreements under SFFAS 54 - no accounting distinction is made. The original lessor and original lessee should both apply the general guidance for lessees and lessors as outlined herein. The original lessee becomes the sublessor in the sublease and should account for the original lease and the sublease as two separate transactions, as a lessee and a sublessor, respectively. The two separate transactions should not be offset against each other. The new sublessee should apply the general lessee guidance.

The original lessee (and now the sublessor in a sublease) should include the sublease in its disclosure of the general description of lease arrangements (one of the disclosure requirements). Sublessor transactions related to sub-leases should be disclosed separately from lessee transactions related to original leases.

Section 7.M: Requirements Related to Presentation and Disclosures (Lessee): The following disclosure requirements are established in SFFAS 54 and should be considered in conjunction with guidance in Circular A-136, Financial Reporting Requirements. Furthermore, OST B30 provides specific reporting requirements through its financial statement and reporting process.

1. **Balance Sheet and Statement of Net Cost Presentation:**
   Lessee – Long-Term Leases: For long-term leases, a lease liability and right-to-use lease asset are recognized on the balance sheet and both an interest expense and lease asset amortization are recognized on the statement of net cost. The interest expense that results from amortizing the discount on the lease liability and the right-to-use lease asset amortization expense is recognized within the appropriate lease-specific accounts.

   Lessee – Intragovernmental Leases: Intragovernmental leases, whether short or long-term, are not recognized on the balance sheet except for:

1) Accruals or deferrals of rental payments that are necessary to account for payments to be made after the current reporting period or payments that benefit more than the current reporting period, and
2) Leasehold improvements made by lessee. All other lease payments are recognized as expenses based on the payment provisions of the lease agreement, including initial direct costs.

Lessee- Short-Term Leases: Short-Term leases are not recognized on the balance sheet except for accruals or deferrals of rental payments that are necessary to account for payments to be made after the current reporting period or payments that benefit more than the current reporting period. All other lease payments are recognized as expenses based on the payment provisions of the lease agreement.

Footnote Disclosures: Disclosures required by SFFAS 54 are extensive and include both qualitative and quantitative information, which should enable DOT stakeholders to understand the amount, timing and uncertainty of cash flows arising from leases.

Below is the information required to be disclosed in footnotes:

Qualitative	Quantitative
Lessee Positions	
A general description of its leasing arrangements including the basis, terms, and conditions on which variable lease payments not included in the lease liability are determined.	The total amount of lease assets and the related accumulated amortization, to be disclosed separately from PP&E assets. The amount of lease expense recognized for the reporting period for variable lease payments not previously included in the lease liability. Principal and interest requirements to the end of the lease term, presented separately, for the lease liability for each of the five subsequent years and in five-year increments thereafter. The amount of the annual lease expense and the discount rate used to calculate the lease liability.
Lessor Positions	
A general description of its leasing arrangements, including the basis, terms, and conditions on which any variable lease payments not included in	The carrying amount of assets on lease by major classes of assets, and the amount of related accumulated depreciation. The total amount of revenue (for example, lease revenue, interest revenue, and any other lease-related revenue) recognized in the reporting period from leases.

Qualitative	Quantitative
the lease receivable are determined.	The amount of revenue recognized in the reporting period for variable lease payments and other payments not previously included in the lease receivable, including revenue related to residual value guarantees and termination penalties.
Intragovernmental Leases	
General description of significant leases (lessors). A general description of significant intragovernmental leasing arrangements, including general lease terms with any applicable specific intragovernmental requirements (lessees).	Future lease payments that are to be received to the end of the lease term for each of the five subsequent fiscal years and in five-year increments thereafter (lessors). Annual lease expense in total and by major underlying asset category (lessees).

Note: Judgement may be involved as certain information may need to be aggregated or disaggregated and immaterial transactions may need to be omitted for the disclosures to faithfully represent DOT's financial situation.

8. **RESPONSIBILITIES:** The following personnel are responsible for implementing this Order.

a. DOT Assistant Secretary for Budget and Programs and Chief Financial Officer: Oversees all financial management activities for the Department, as outlined by the Chief Financial Officers Act of 1990 and provides policies on all Department's financial management activities:
1) Provides leadership and oversight on all aspects of accounting for leases;
2) Sets forth guidance to DOT to account for and report certain leases of PP&E as directed by this Order, which includes determining whether a contract or agreement meets the definition of a lease as established by SFFAS 54, and
3) Requires DOT OAs to follow FASAB's and Treasury's TFM and USSGL guidance when recording applicable lease transactions and events.

b. Office of Financial Management (B30): B30 serves as the designated senior official responsible for:
1) Assisting DOT OAs and program areas in meeting the requirements and directions of this Order;
2) Coordinating an overall Department-wide approach of reviewing, improving, and reporting on leases in accordance with this Order; and
3) Preparing and submitting the financial reporting for the Department.

c. DOT OA CFOs: OA CFOs must follow and carry out the policies of this Order:

1) Ensure the directions in this Order relating to leases are followed.
2) Manage their leases with effective administration and control to ensure accurate financial reporting; and
3) Establish effective accountability at each echelon of their organization to provide optimum protection against fraud, waste, misuse, and abuse of Government-leased PP&E during receipt, use, movement, maintenance, and disposal phases.
4) Develop, implement, document, and monitor procedures to operationalize the policy guidance contained within this order as it pertains to each OA; this may include the assignment of steps defined herein (lease identification, term assessment, etc.) to those responsible for execution of lease financial accounting and reporting.

VICTORIA BAECHER WASSMER Digitally signed by VICTORIA BAECHER WASSMER Date: 2024.09.06 16:57:30 -04'00'

Victoria B. Wassmer
Assistant Secretary for Budget and
Program and Chief Financial Officer

Date

Appendix A: Lease Decision Tree

As noted in section H, contracts may contain multiple distinct assets or services that are to be conveyed by one party to the other. These various contract items must be accounted for as separate contracts or agreements, and each must be assessed against the criteria for constituting a lease under the lease accounting guidance. Appendix A provides a decision tree of questions to be answered about a particular contract in order to assess its components against the criteria. This decision tree takes as inputs the lease term and payments determined during assessment procedures as described in chapters 2 and 3.

For contracts with multiple deliverables/components, SFFAS 54 scope assessment is required to be completed at the contract component level **(SFFAS 54 Pars. 72-77):**

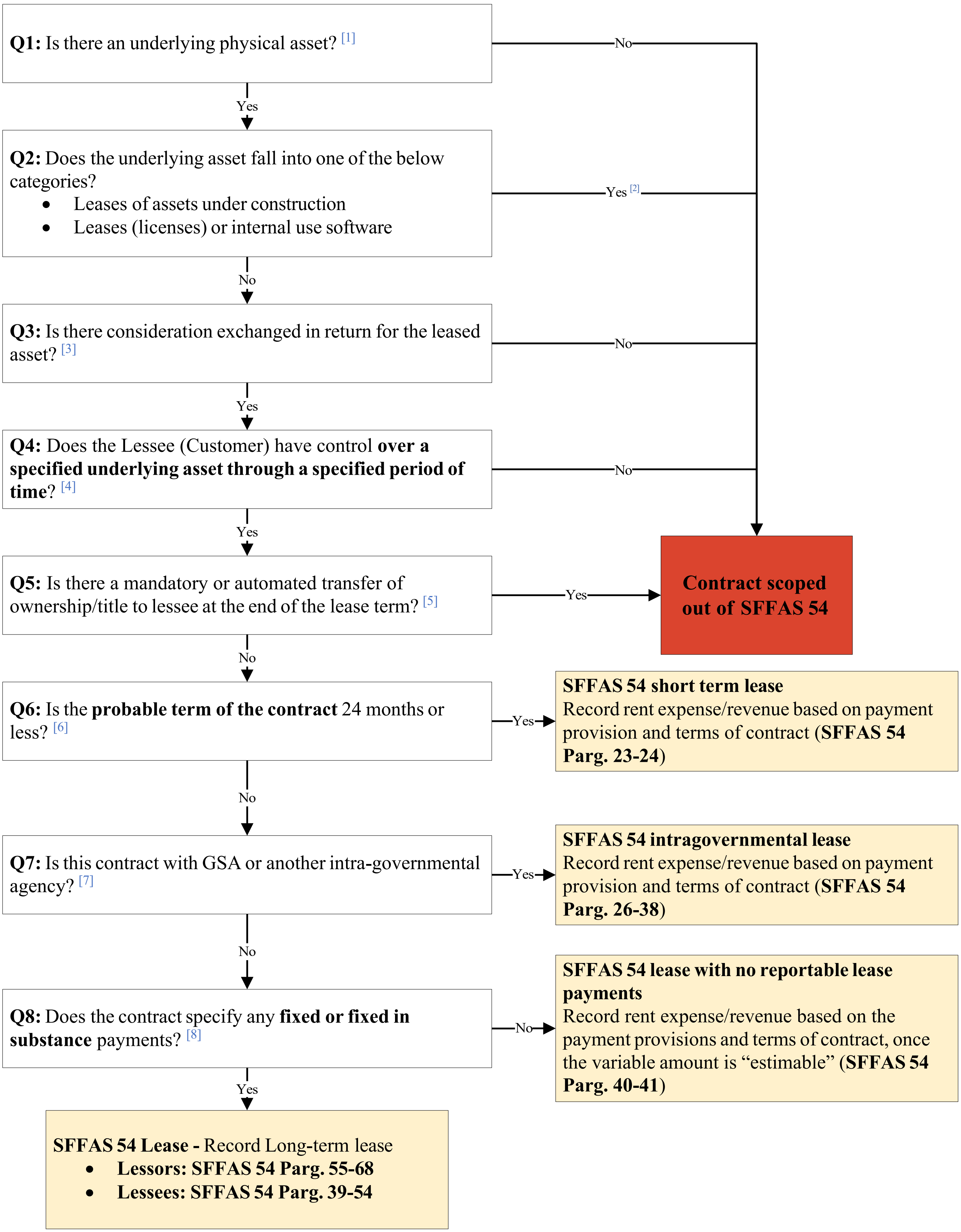
a. This may result in "parts" of certain contracts being deemed "embedded leases" scoped into SFFAS 54 while the remainder of the contract may be comprised of nonlease components subjected to other FASAB guidance outside SFFAS 54.
b. SFFAS 54 does not provide an option allowing bundling of nonlease and lease components embedded in a single host contract. Reporting entities are required to bifurcate lease and nonlease components unless it is not "practicable" to determine a best estimate for price allocation for some or all components in a contract (Note: "Not practicable" is a high hurdle, not one that should be applied by default).
c. For certain contracts scoped out of SFFAS 54, audit trail may be warranted to demonstrate absence of "lease components" that may be embedded in contracts.

As an example of treating multiple components separately, if there is an arrangement contractually labelled as "software licensing agreement", which provides the Federal Entity rights to use a software (i.e., intangible asset) while also providing the Federal Entity rights to control physical servers that are dedicated to hosting the Federal Entity's data through the duration of this arrangement, the accounting for the contract may need to be bifurcated between two distinct components:

a. Rights to use software – subject to accounting requirements of SFFAS 10, Accounting for Internal Use Software; and
b. Rights to control physical servers throughout the contract period – subject to accounting requirements of SFFAS 54, Leases.

Each component would be subject to the decision tree below separately in deriving conclusions on whether they are within the scope of SFFAS 54 or not.

In addition, certain scope exceptions can be addressed at a "portfolio level." For example, the conclusion can be reached that scope exceptions around leases of software would not be applicable to an agency's lease portfolio as the agency's operational activities do not involve software licenses. For audit purposes, such conclusions can be corroborated via discussions with procurement. Certain other scope exceptions (e.g., whether leases all contain consideration) may warrant a closer look at the lease transactions portfolio. In the decision tree below, the footnotes (FNs) are listed 1 through 8 and are explained in the FN explanation table.


Q1: Is there an underlying physical asset? [1]
No
Yes
Q2: Does the underlying asset fall into one of the below categories?
• Leases of assets under construction
• Leases (licenses) or internal use software
Yes [2]
No
Q3: Is there consideration exchanged in return for the leased asset? [3]
No
Yes
Q4: Does the Lessee (Customer) have control over a specified underlying asset through a specified period of time? [4]
No
Yes
Q5: Is there a mandatory or automated transfer of ownership/title to lessee at the end of the lease term? [5]
Yes
Contract scoped out of SFFAS 54
No
Q6: Is the probable term of the contract 24 months or less? [6]
Yes
SFFAS 54 short term lease
Record rent expense/revenue based on payment provision and terms of contract (SFFAS 54 Parg. 23-24)
No
Q7: Is this contract with GSA or another intra-governmental agency? [7]
Yes
SFFAS 54 intragovernmental lease
Record rent expense/revenue based on payment provision and terms of contract (SFFAS 54 Parg. 26-38)
No
Q8: Does the contract specify any fixed or fixed in substance payments? [8]
No
SFFAS 54 lease with no reportable lease payments
Record rent expense/revenue based on the payment provisions and terms of contract, once the variable amount is “estimable” (SFFAS 54 Parg. 40-41)
Yes
SFFAS 54 Lease - Record Long-term lease
• Lessors: SFFAS 54 Parg. 55-68
• Lessees: SFFAS 54 Parg. 39-54

#	FOOTNOTE (FN)
1	Contracts that are structured as lease or rent agreements (i.e., labelled as such on the face of the document) typically meet the specified asset, control, and specified period of time requirements. On the other hand, embedded leases that are hosted in contracts that are not explicitly labelled leases (e.g., service agreements, public-private partnership agreements, licenses, etc.) typically warrant further assessment and consideration of criteria listed in Q3 (i.e., specified asset, control over such asset, specified period of time). **<u>ASSESSMENT OF SPECIFIED ASSET CRITERIA</u>** **Implicit vs. explicit assets:** Certain service arrangements may contractually identify PP&E needed for related performance obligation by reference to a serial number, VIN, GPS (Global Positioning System) coordinates, etc. In other cases, such PP&E may be implicitly specified at the time the asset is made available for use to the customer (e.g., physical server tailored to unique security requirements even though server serial number is not explicitly specified in the contract). Both meet the definition of a lease. **Substitution rights:** If the vendor holds the right to replace the underlying asset with an essentially identical asset, the lease will still pass the control criteria since the lessee will still be able to maintain control of the economic benefit or service from the use of another entity's underlying asset.
2	**Transaction scoped out of SFFAS 54 -** Record expense/revenue based on the payment provisions and terms of contract
3	Consideration can be monetary or non-monetary. For example, in-kind services can also be consideration. **If answer is no,** transaction scoped out of SFFAS 54 assets where no consideration is exchanged are to be recorded as inflows of resources **(SFFAS 7 Para. 48-63)**.
4	**<u>ASSESSMENT OF CONTROL CRITERIA</u>** To determine whether a contract conveys control of the right-to-use the underlying asset, a Federal Entity should assess whether it has both of the following: The right to obtain economic benefits or service from use of the underlying asset as specified in the contract or agreement. In order to have control over the economic benefits of a specified asset you do not have to have physical possession, nor must lessee personnel be those who operate the asset. In order to have control over the economic benefits of a specified asset you do not have to have access to all the economic benefits of the asset, just those conveyed in the contract. No one else should be able to use the contract-specified economic benefits from the asset and/or you can prevent anyone else from using those benefits. The right to control access to the economic benefits or services of the underlying asset as specified in the contract or agreement. Rights to direct how and for what purpose the identified (portion of) asset is used throughout the period of use; and Right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions.

#	FOOTNOTE (FN)
	Designed the asset (or specific aspects or the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. In order to have control over the economic benefits of the specified asset you do not have to have access to the asset 24 hours a day. Access can be a limited period as long as it is specified in the contract. **If answer is no, transaction scoped out of SFFAS 54 –** Record expense/revenue based on the payment provision and terms of contract.
5	**PP&E Purchase/Sale** – Account for contract as purchase/sale of underlying property (SFFAS 54, Para. 25).
6	**ASSESSMENT SPECIFIED PERIOD OF TIME CRITERIA** **Permanent easements** and other contracts that do not "specify" a period of time do not meet the definition of a lease. **Period of use (or control)** does not have to be "uninterrupted" through the course of time; it must be present during specified contractual periods during which the customer is given access to the underlying asset. **Lease term is defined as a noncancellable** period plus certain periods subject to options to extend or terminate the lease. The noncancelable period is the shorter of: The period identified in the lease contract or agreement that precedes any option to extend the lease or The period identified in the lease contract or agreement that precedes the first option to terminate the lease.
7	Lease that is a contract or agreement occurring within a consolidation entity or between two or more consolidation entities, whereby one entity (lessor) conveys the right to control the use of PP&E (the underlying asset) to another entity (lessee) for a period of time as specified in the contract or agreement for consideration.
8	Payments that are contingent on future events (e.g., sales, production volume, etc.) are considered variable to the extent there are no "minimum guarantees" buried in such payment structures. Future CPI adjustments are also considered variable in nature. CPI should initially be measured using the index or rate as of the commencement of the lease term and included in the lease liability.