**Resolution for Approval Process for Leases under Governmental Accounting Standards Board Statement No. 87**

**FINANCE AND RESOURCE MANAGEMENT COMMITTEE**

**May 21, 2021**

Background:

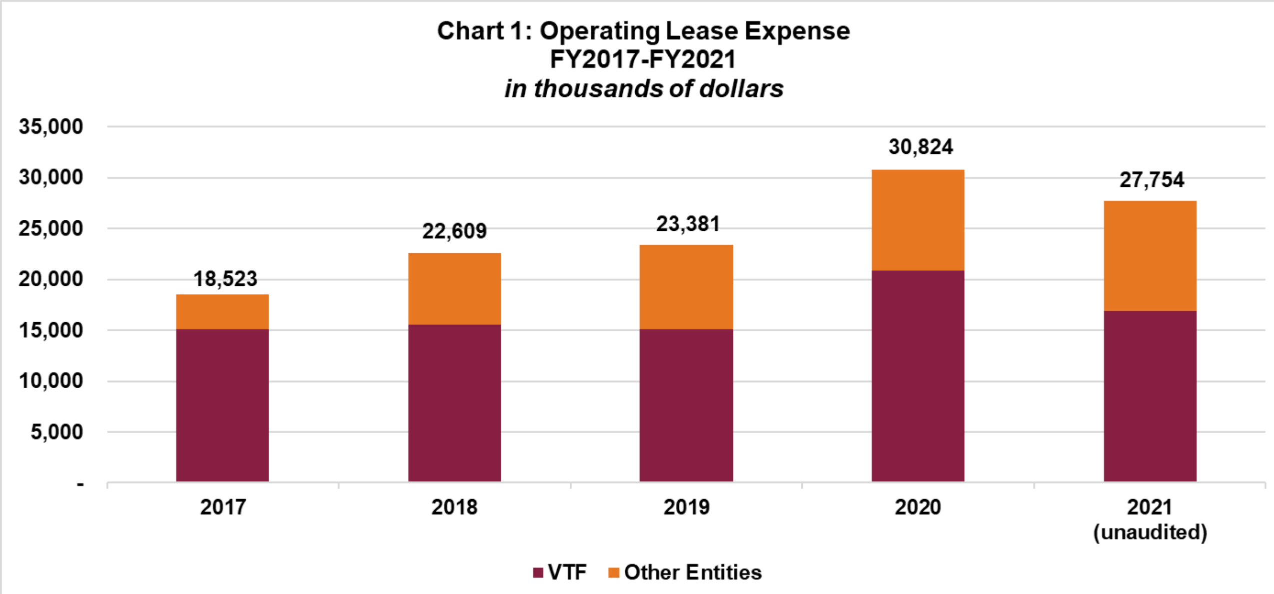
The university's accounting and financial reporting practices follow and are consistent with the Governmental Accounting Standards Board (GASB). The GASB's long-standing guidance on reporting real estate and equipment leases distinguished between operating and capital leases. Under this guidance, most university leases were classified as operating leases with payments treated as operating expenses, while a limited number of leases met the capital lease criteria and are included on the balance sheet as tangible fixed assets with corresponding long-term liabilities. The university recognizes capital lease expense through depreciation and interest.

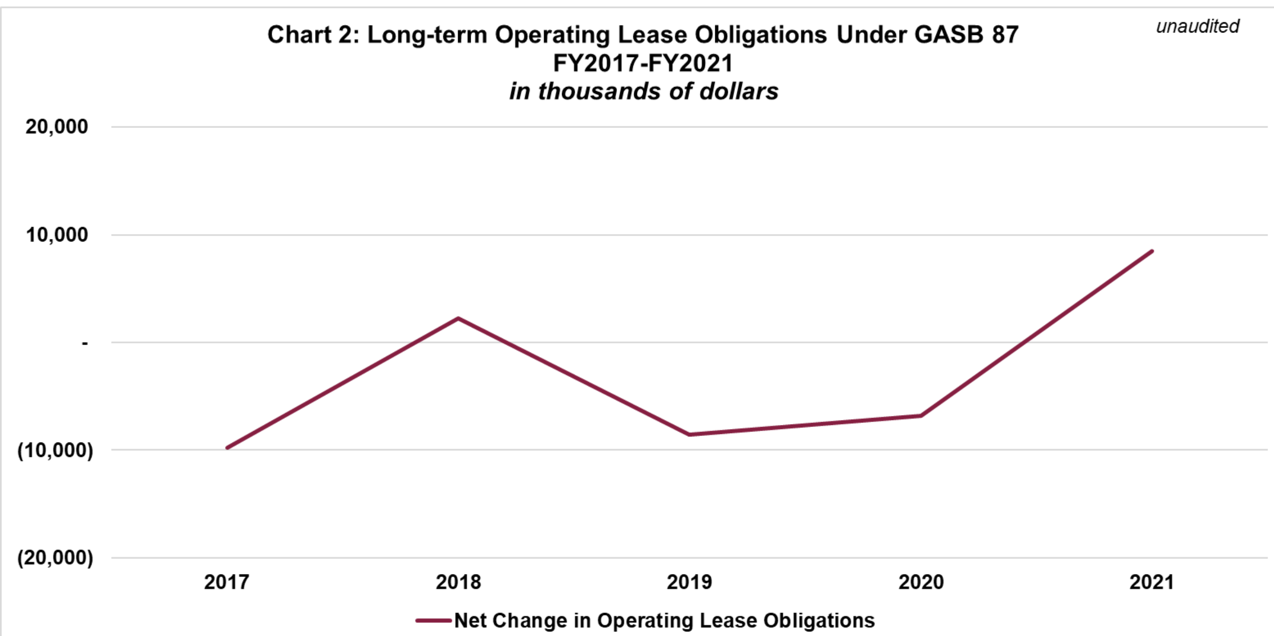
In 2017, GASB issued Statement No. 87, revising governmental lease accounting effective July 1, 2020 for the university. The COVID-19 pandemic prompted GASB to release Statement No. 95 delaying the effective date and the university's implementation to July 1, 2021. The new standard eliminates the distinction between operating and capital leases in favor of a distinction between short-term and long-term leases. The standard for a short-term lease is defined as a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months, including any options to extend, regardless of the probability of being exercised. Additionally, the Virginia Department of Accounts established that leases with a present value of less than $50,000 will be treated as short-term. The university will continue to recognize operating expense for its short-term leases.

All leases that exceed 12 months and have a present value of at least $50,000 will be considered long-term leases and recorded as intangible right-to-use assets with corresponding long-term liabilities on the balance sheet. Under this new reporting standard, most university leases will be recognized as long-term lease obligations increasing the university’s outstanding long-term debt. For long-term leases, the university will recognize expense through amortization and interest.

Historical Operating Lease Activity:

The university has recognized annual rent expense averaging $24.6 million per year on its operating lease portfolio, as shown in Chart 1. Chart 2 shows the net change in the university's operating lease obligations due to new and renewed lease agreements and lease payments on existing operating leases.




Over the past five years, an average of 16 new or renewed operating lease agreements with terms over 12 months and a present value of at least $50,000 were executed annually. Of those agreements, three operating leases with present values greater than $3 million did not meet the university's previous capitalization criteria.

Historically, the Virginia Tech Foundation (VTF) represents nearly 75 percent of the university's lease obligations, and the university benefits from these breakeven rent agreements. Two-thirds of the leases have a present value under $500,000 and make-up eight percent of the total obligation. Chart 3 reflects the approximate value and number of capital leases approved by the Board of Visitors and operating leases administratively authorized by the university that will impact the balance sheet as of July 1, 2021.

**Chart 3: Estimated Long-Term Lease Obligations as of 7/1/2021**
**(dollars in thousands)**

| | VTF | Other Entities | Grand Total |
|---|---|---|---|
| | **Dollars ($)** | **Dollars ($)** | **Dollars ($)** |
| **Value** | | | |
| Former capital leases[1] | | | |
| Greater than $500k | $ 68,856 | $ 3,478 | $ 72,334 |
| Less than $500k | 182 | - | 182 |
| Total former capital leases | $ 69,038 | 3,478 | $ 72,516 |
| Former operating leases[2] | | | |
| Greater than $500k | $ 37,186 | $ 30,564 | $ 67,750 |
| Less than $500k | 5,585 | 6,055 | 11,640 |
| Total former operating leases | $ 42,771 | $ 36,619 | $ 79,390 |
| **Total value of long-term leases** | **$ 111,809** | **$ 40,097** | **$ 151,906** |
| **% of Grand Total** | **73.6%** | **26.4%** | **100.0%** |
| | **Number** | **Number** | **Number** |
| **Number** | | | |
| Former capital leases[1] | | | |
| Greater than $500k | 9 | 1 | 10 |
| Less than $500k | 1 | 0 | 1 |
| Total former capital leases | 10 | 1 | 11 |
| Former operating leases[2] | | | |
| Greater than $500k | 13 | 8 | 21 |
| Less than $500k | 22 | 31 | 53 |
| Total former operating leases | 35 | 39 | 74 |
| **Total number of long-term leases** | **45** | **40** | **85** |
| **% of Grand Total** | **52.9%** | **47.1%** | **100.0%** |

[1]Approved by the Board of Visitors
[2]Approved by management

<u>Impact on the Balance Sheet</u>:

At the start of fiscal year 2022, the university expects to recognize approximately $79 million of intangible right-to-use assets and corresponding long-term debt liabilities formerly classified as operating leases. This amount reflects the discounted value of future lease payments as of the balance sheet date and increases total long-term debt liabilities on the balance sheet to $591 million from $512 million, or a 15 percent increase at July 1, 2021. Over the life of the lease, the amortization expense on the lease asset and interest expense on the lease liability is equivalent to the rent expense recognized under the old standard, as displayed in Chart 4.

| Chart 4: Changes in Reporting for Operating Leases Under GASB 87<br>Example: Two-Year Lease | | | | |
|---|---|---|---|---|
| | **Year 0** | **Year 1** | **Year 2** | **Cumulative** |
| **Lease Payments** | - | 51,815 | 51,815 | 103,630 |
| **Current Reporting** | | | | |
| **Balance Sheet** | | | | |
| Asset | - | - | - | - |
| Liability | - | - | - | - |
| **Income Statement** | | | | |
| Rent Expense | - | 51,815 | 51,815 | 103,630 |
| Amortization Expense | - | - | - | - |
| Interest Expense | - | - | - | - |
| **GASB 87** | | | | |
| **Balance Sheet** | | | | |
| Asset | 100,000 | 50,000 | - | - |
| Liability | 100,000 | 50,935 | - | - |
| **Income Statement** | | | | |
| Rent Expense | - | - | - | - |
| Amortization Expense | - | 50,000 | 50,000 | 100,000 |
| Interest Expense | - | 2,750 | 880 | 3,630 |

Impact on Debt Ratio:

The State's Institutional Performance Standards and the university's debt policy require the university to maintain a debt service to operations ratio of no greater than seven percent. In addition to the seven percent limitation, the Board of Visitors has provided long-term guidance for the university to manage the debt ratio within a five percent benchmark. Based on a review of the university's operating lease portfolio, the anticipated impact is an average increase of 110 basis points or 1.1 percentage points to the projected debt ratio beginning in fiscal year 2022. Attachment A shows a multi-year projection of the impact of GASB Statement No. 87 on the debt ratio. The university will provide updates on the impact in the normal annual Debt Capacity and Debt Ratio Report, traditionally on the November meeting agenda.

Impact on Credit Ratings:

The university has discussed the potential impact of GASB Statement No. 87 on its credit ratings with S&P Global, Moody's, and the university's financial advisor Public Resources Advisory Group. The prevailing conclusion is GASB Statement No. 87 is not expected to impact the university's credit rating because the agencies have historically included operating lease expenses in their credit analysis.

Space Management:

In 2018, the President approved *University Policy 5400 University Space Management* to support formal decision-making with a comprehensive approach to space management. The policy makes all university stakeholders responsible for the effective use of space as a valuable and shared resource. The university has the authority and responsibility to allocate space through organizational hierarchies for certain periods of time, review those allocations periodically, assess their utilization, and reallocate as needed to support the university's strategic goals. The policy established a committee structure, the Executive Space Committee (ESC) and the University Space Committee (USC), to provide a formal process for evaluating and making space decisions. One space management principle is to "ensure that overall utilization meets university targets and that overall cost/benefit is considered when weighing alternative lease arrangements, renovations, new construction, or land acquisition." The Office of Real Estate Management is responsible for negotiating, executing, and managing of all leases, license agreements, and general agreements for real property approved by the ESC and USC.

Proposal for Approval Process for Future Leases:

The university's Management Agreement with the Commonwealth requires that leases that meet the GAAP criteria for capital leases be treated as capital projects that require authorization by the Board of Visitors. However, under GASB Statement No. 87, capital leases do not exist, and the state has not provided new guidance on the authorization process for the newly defined long-term leases.

Until such time as further guidance is provided regarding authorization processes for leases, the university recommends a process that continues appropriate review and approval for entering into lease agreements as follows:

- i) new and renewal leases with terms that obligate future resources with a present value equal to or greater than the dollar value threshold for capital projects in the Management Agreement are approved by the Board of Visitors prior to execution;
- ii) new and renewal leases with terms that include property ownership transfer, including bargain purchase options, to the lessee are reviewed and approved by the Board of Visitors prior to execution;
- iii) all other new and renewal leases, short-term and long-term, less than the dollar value threshold for capital projects in the Management Agreement and not including property ownership transfer will continue to be administered by the university; and
- iv) new and renewal leases administered by the university with a present value equal to or greater than $50,000 are reviewed and ratified by the Board of Visitors annually.

These processes will provide an enhanced set of controls for entering leases with a present value equal to or greater than $50,000 and similar controls for leases greater than the dollar value threshold for capital projects, currently $3 million, compared to the processes for entering leases prior to implementation of GASB Statement No. 87.

**RESOLUTION FOR APPROVAL PROCESS FOR LEASES UNDER GOVERNMENTAL ACCOUNTING STANDARD BOARD STATEMENT NO. 87**

**WHEREAS,** the Governmental Accounting Standards Board (GASB) issued Statement No. 87 in 2017 which revises governmental lease accounting for the university effective July 1, 2020; and,

**WHEREAS,** GASB issued Statement No. 95 postponing the effective date of Statement No. 87 for the university to July 1, 2021; and,

**WHEREAS,** Statement No. 87 eliminates the traditional distinction between operating leases and capital leases and uses new definitions to classify short-term leases and long-term leases; and,

**WHEREAS,** the university expects to recognize approximately $79 million of long-term leases currently classified as operating leases as intangible right-to-use assets and corresponding long-term debt liabilities at the start of fiscal year 2022 as a result of GASB Statement No. 87; and,

**WHEREAS**, the State's Institutional Performance Standards and the university's debt policy as approved by the Board of Visitors require the university to maintain a debt service to operations ratio of no greater than seven percent; and,

**WHEREAS,** prior to GASB Statement No. 87, operating leases were approved by university administration through a formal space management process; and under the university's Management Agreement with the state, leases that met the GASB capital lease thresholds were defined as capital projects and approved by the Board of Visitors; and,

**WHEREAS,** to ensure the continuation of appropriate reviews and approvals for leases, the university will establish processes and procedures for lease approvals; and,

**WHEREAS,** the university recommends a process that continues appropriate review and approval for entering into lease agreements as follows: i) new and renewal leases with a present value equal to or greater than the dollar value threshold for capital projects in the Management Agreement are approved by the Board of Visitors prior to execution, ii) new and renewal leases that include property ownership transfer to the lessee, including bargain purchase options are approved by the Board of Visitors prior to execution; iii) all other new and renewal leases will continue to be administered by the university; iv) new and renewal leases administered by the university with a present value equal to or greater than $50,000 are ratified by the Board of Visitors annually;

**NOW, THEREFORE BE IT RESOLVED,** that the university be authorized to proceed with developing and implementing processes and procedures for executing and administrating leases in accordance with the conditions set forth in this resolution; and

**BE IT FURTHER RESOLVED,** that the Board of Visitors ratifies long-term leases of approximately $79 million to be recognized as long-term debt liabilities on the balance sheet as of July 1, 2021; and

**BE IT FURTHER RESOLVED,** that the university be authorized to administer new and renewal leases which do not exceed the current dollar value threshold for capital projects in the Management Agreement or transfer ownership of property to the university.

**RECOMMENDATION:**

The Board of Visitors authorizes management to implement the proposed approval processes for leases, ratifies $79 million of long-term leases to be recognized as of July 1, 2021, and authorizes the university to administer new and renewal leases less than the current dollar value threshold for capital projects in the Management Agreement.

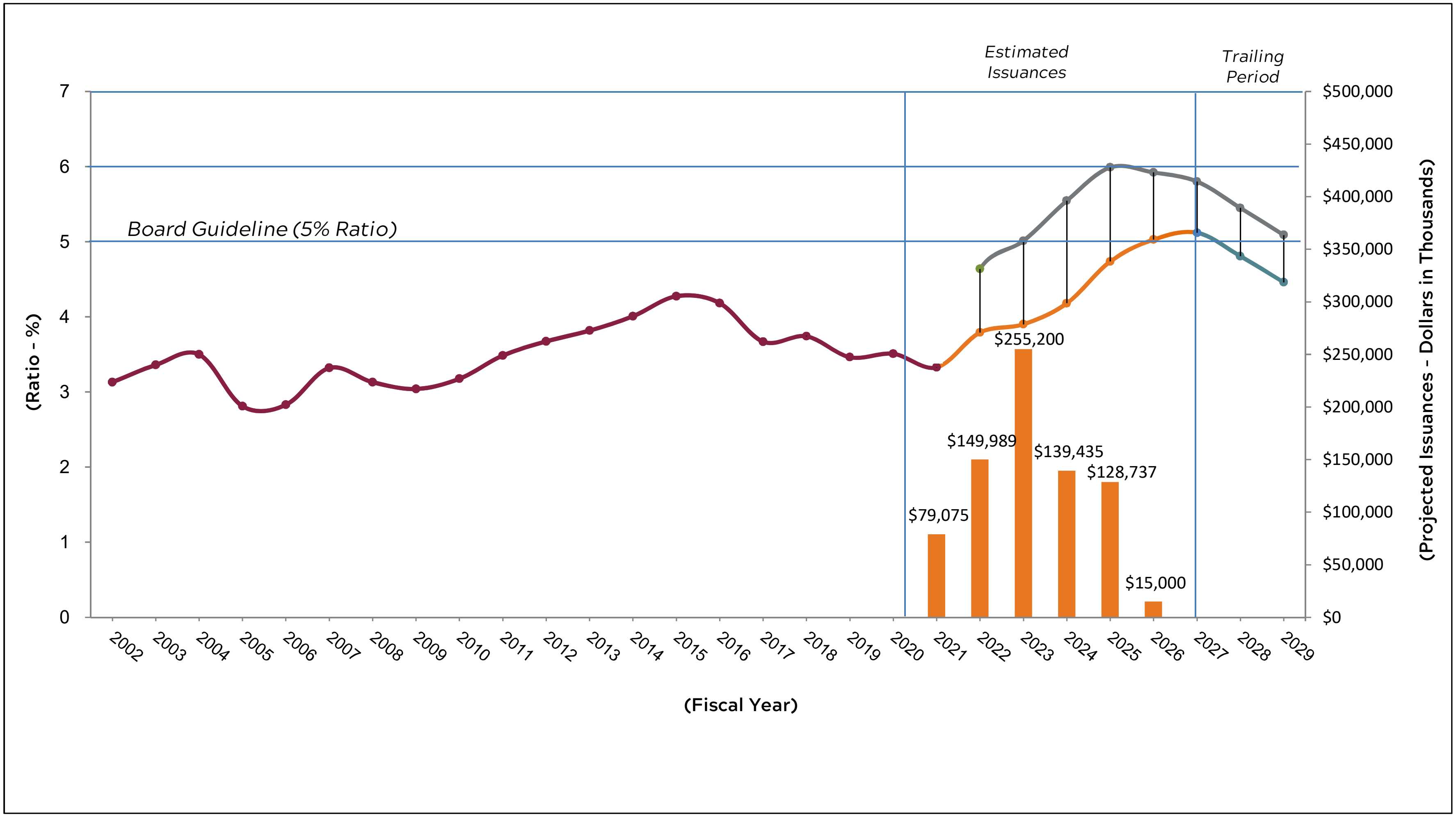
June 8, 2021

Attachment FF
Attachment A

**University Debt Ratio Trend**
**Projected Impact of GASB 87 - - Inclusion of Operating Leases**

**FINANCE AND RESOURCE MANAGEMENT COMMITTEE**

**April 24, 2021**




Maroon = Actual Debt Burden Ratio
Orange = Projected Debt Burden Ratio
Blue = Trailing Period Debt Burden Ratio
Bar = Projected Issuances
Gray = Impact of Operating Leases

*Presentation Date: June 8, 2021*