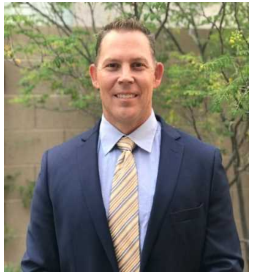
GASB 87: Understanding and Implementing the New Lease Accounting Standard

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

Create Opportunities

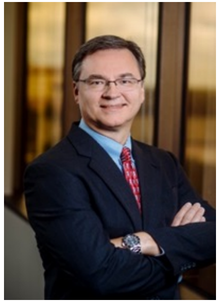
Today's Presenters

Dennis J. Osuch



Dennis is a principal in CLA's state and local government industry team with more than 24 years of experience. He also serves as the Phoenix industry leader for our state and local governments. Although Dennis manages our local state and local government industry. His role is largely focused on serving our clients with the experience and knowledge you would expect from a national firm. Dennis has served on CLA's government steering committee and thought leadership team and is a past board member of the Desert School Federal Credit Union.

Walker D. Wilkerson



Walker is a principal with CLA and has 30 years of public auditing experience with a focus on government and nonprofit entities. He has served as a member of the AICPA's State and Local Government Expert Panel and as a reviewer for theGFOA Certificate of Excellence in Financial Reporting program. Additionally, Walker is an international speaker and has served as an adjunct professor at Florida Southern College teaching a variety of accounting courses.

Learning Objectives

At the end of this session you will be able to:

- Determine whether an arrangement contains a lease as defined in GASB Statement No. 87.
- Calculate and prepare required journal entries for lessees and lessors
- Determine the lease term
- Recognize both qualitative and quantitative disclosure requirements
- How to begin your journey

Your Journey Begins

Read GASB 87

Create a GASB 87 Team

Gather lease information

Triage

Software considerations

Journal entry and disclosures

Other Considerations

GASB 87 – why the change?

- Previous lease standards allowed operating leases to be reported in a way that did not truly reflect the commitments made by the lessee.
- No liability was reported even though all leases result in a commitment to make lease payments.
- GASB 87 brings governmental reporting in line with FASB and IASB standards.

5 Biggest Changes

- Operating leases are removed from lease classification; <u>all leases</u> are financings of the right-to-use an underlying asset
- Lease payments are capital financing outflows (instead of operating outflows), and lease expense will be interest on the liability and right-to-use asset amortization (instead of operating rent expense)
- Lessors will mirror lessees and recognize a lease receivable and corresponding deferred inflow of resources, while continuing to report the asset underlying the lease (distinctions of Sales-type, Direct-financing and Operating leases are removed)
- Lessor lease revenue recognized from amortizing the deferred inflow of resources
- Increased financial statement disclosures

Effective Date

- Effective for reporting periods beginning after June 15, 2021 (fiscal years ending June 30, 2022 and thereafter)
- For leases that were reported as operating leases prior to the implementation of Statement 87, the leases should be measured using the facts and circumstances that existed at the beginning of the period of implementation.

Definition of a Lease

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

An identified nonfinancial asset

Is explicitly or implicitly specified

+

Convey control of the right to use asset during the term

Right to obtain the present service capacity from use of the underlying asset

Right to determine the nature and manner of use of the underlying asset

Exclusions

- Biological Assets
- Conduit Debt Arrangements (GASB91)
- Service Concession Arrangements/PPP or APA Arrangements (GASB 60/94)
- Inventory
- Intangible Assets (mineral rights, patents, software, copyrights)
- Supply Contracts
- Subscription Based IT Arrangements (GASB 96)

Categories of Leases

Introduces three categories of leases:

- Short-Term Leases
  - Lease term is 12 months or less, including any extension periods
  - Recognize expense (lessee) and revenue (lessor) based on contract provisions, as due
- Contracts that Transfer Ownership
  - Term typically longer than 12 months
  - Recognize a sale of the underlying asset (gain or loss)
- Long-term Leases
  - Longer than 12 months

Financial Statement Impact (Lessee)– Financing & Short-Term Lease

	Statement of Net Position	Statement of Activities	Statement of Cash Flows
Financing Lease	• Intangible Right-to-Use Asset (subject to GASB 42 impairment guidance) • Lease Liability	• Amortization expense • Interest expense • Payments first allocated to accrued interest liability and then to lease liability	• Interest & Lease Principal = Capital & Related Financing
Short-Term Lease	N/A (unless payments are made in advance or subsequent to the reporting period)	• Lease expense • Based on payment provisions of the contract • Not straight-lined for rent holiday	• Operating

Similar to former Operating Lease treatment under GASB 13

Initial Recording - Lessee

- Lease Asset (right to use asset) – Initial measurement of lease liability, plus prepayments and initial direct costs to place asset in service, less any lease incentives received at or before lease commencement.
- Liability - Present Value of future lease payments for the lease term
- Governmental funds – expenditure and other financing source should be reported in the period the lease is initially recognized

Case Study #1 – Copiers (Lessee)

- Lease Commencement Date: August 1, 2021
- Full Lease price: $52,743.04
- Lease Term: 3 Years
- Options: 2 years, expect to extend (Only Lessee has option to cancel)
- Stated Interest Rate: 6%
- PV of min lease payments: $38,526.49
- Payment due at the beginning of the month - $879.05 (includes $137.93 of maintenance costs)
- 12/31/2021 Year End Entity

Case Study #1 – Copiers (Lessee)

Accrual Accounting

Initial entry to record lease:

Dr. Right-to-Use Asset	38,526.49	
Cr. Lease Liability		38,526.49

End of Year Entry 12/31/2021:

Dr. Amortization Expense: Right-to-Use Asset	3,210.54	
Cr. Accumulated Amortization: Right-To-Use Asset		3,210.54

Dr. Lease Liability	2,966.51	
Dr. Interest Expense	739.09	
Dr. Maintenance/Toner Expense	689.65	
Cr. Cash		4,395.25

Case Study #2 – Vehicles (Lessee)

- Lease Commencement Date: August 1, 2019
- Previously reported as a capital lease asset – Value at 1/1/2021 = $8,258.84
- Lease Term: 3 years; Lease Liability at 1/1/2021 is ($8,629.32)
- Options: At 1/1/2021; they decide to extend the lease by 2 years
- Stated Interest Rate: 6%
- Payment due at the beginning of the month - $500

<u>Updated Calculations</u>

- 1/1/2021 Balance with Options: $20,603.60 (RTU Asset)
- 1/1/2021 Liability: $20,603.60

Case Study #2 – Vehicles (Lessee)

Accrual Accounting

<u>Initial entry at 1/1/2021:</u>

Dr. Right-to-Use Asset	12,344.76	
Cr. Lease Liability		11,947.28
Cr. Prior Period Adjustment		370.48

Financial Statement Impact (Lessor)– Financing & Short-Term Lease

	Statement of Net Position	Statement of Activities	Statement of Cash Flows
Financing Lease	• Lease Receivable • Deferred inflow of resources • Continue to recognize underlying asset	• Lease revenue (reduction of deferred inflow of resources) • Interest revenue • Payments first allocated to accrued interest receivable and then to lease receivable	• Interest & Lease Principal = Capital & Related Financing
Short-Term Lease	N/A (unless payments are received in advance or subsequent to the reporting period)	• Lease revenue • Based on payment provisions of the contract • Not straight-lined for rent holiday	• Operating

Initial Recording - Lessor

- Lease Receivable – Present Value of future payments
- Continue to report the leased asset
- Deferred Inflows – Equal to lease receivable plus any cash received up front related to future periods.

Implementation Considerations

Right of Substitution

- A contract that allows the lessor to replace the underlying asset with an identical asset (substantive substitution right) DOES NOT affect the application of GASB 87
- A lease conveys control of the *right to use* another entity's asset. That right is distinct from the underlying asset.

Supply Contract vs. Lease

Lease?

Supply Contract?

Supply Contracts	Contracts that are intended to result in the purchase or sale of a *commodity* used in the normal course of operations.
	Normally do not convey the right to use the underlying asset.

But wait….it depends…it could be a lease

Example: Supply Contract

To obtain access to additional power during the warmest months of the year, Entity A enters into a contract with a Company B for electricity from March through October for three years.

Entity A makes fixed payments to obtain exclusive rights to the present service capacity and to determine the nature and manner of use of the turbine used to generate the electricity.

In addition, the government makes variable payments that are based on actual usage and output.

Does this contract include a lease?

Answer: Supply Contract

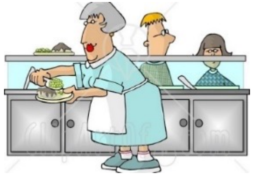
Yes!

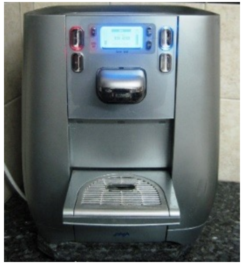
While the Board stated that GASB 87 does not apply to supply contracts, this contract conveys control of the right to use the underlying asset (implicit asset = turbine) as specified in the contract for a period of time in addition to the right to the output generated by the underlying asset.

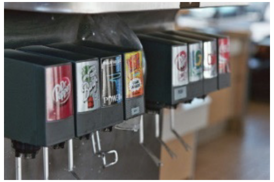
The portion of the contract that requires fixed payments pertains to the full control of the asset (assumed to be a turbine) and meets the definition of a lease.

Other Examples of Embedded Leases in Service Contracts

- Cafeteria?
- Soda fountains?
- Water coolers?
- Coffee machines?







Separating Lease and Non-lease Components

Separate lease components from non-lease components (e.g., copy machine plus toner cartridges)

Services are non-lease components (e.g., maintenance, CAM, utilities)

Allocate the contract price based on 'reasonable' individual component prices

Maximize the use of observable information in estimates, if individual prices are not available or unreasonable

Only if estimating individual prices is **not practical**, may multiple component contracts be accounted for as a single lease unit

GASB: 'inconvenient' does not fall under 'not practical'!

Lease Term

The lease term is the period during which a lessee has a **noncancelable right** to use an underlying asset, plus the following periods, if applicable:

Keep in mind, these have to be reasonably certain (of being/not being) exercised, based on all relevant factors…

- Periods covered by a lessee's option to extend the lease
- Periods covered by a lessee's option to terminate the lease
- Periods covered by a lessor's option to extend the lease
- Periods covered by a lessor's option to terminate the lease

Lease Term… Keep in Mind

- Rolling month-to-month or holdover leases are cancelable if both lessee and lessor have option to terminate at any time.

- Periods where both lessee and lessor have an option to terminate without permission from the other party (or if both parties have to agree to extend) are cancelable periods and excluded from the lease term.

Example: Lease Term

A lease contract allows either party to cancel the lease at any time but also provides for cancellation penalties.

Are the cancellable periods excluded from the lease term?

Answer: Lease Term

Periods for which both the lessee **and** the lessor have an option to terminate the lease without permission from the other party shall be excluded from the lease term as cancellable periods.

The presence of cancellation penalties does not affect this conclusion.

Example: Lease Term

A lease contract allows only the lessee to cancel the lease at any time but also provides for cancellation penalties.

Are the cancellable periods excluded from the lease term?

Answer: Lease Term

Periods covered by **either** a lessee or a lessor option to terminate the lease should be included in the lease term if it is reasonably certain, based on all relevant factors, that the lessee or lessor will not exercise the option.

Lease Term: Example

Entity enters into a 12-month lease with the lessee having an option to renew for another month.

Is this agreement a short-term lease under GASB 87?

Lease Term: Example - Answer

No. The maximum possible term is required to be 12 months or less, including any options to extend.

The presence of lessee renewal options, regardless of their probability of being exercised, means this lease does not meet the definition of a short-term lease.

Other Considerations

Discount rate

- Lessees
  - Interest rate charged by lessor, which may be an implicit rate (when determinable)
  - The lessee’s incremental borrowing rate (default)
- Lessors – rate it charges the lessee
- Discount rates should only be reassessed in the following instances:
  - Lessee - Upon a change in the lease term or a change in determination as to whether the lessee is reasonably certain to exercise a purchase option.
  - Lessor - Upon a change in lease term or a change in interest rate charged to the lessee.

Subsequent Measurement

- The following events would trigger a possible re-measurement of the assets/liabilities
  - Change in lease term
  - Change in interest rates
  - Change in payment amount, including pattern of fixed and variable payments
  - Change in likelihood of residual value and purchase options
- When lease liabilities are re-measured, lease assets should be adjusted by the same amount.
- When lease receivables are re-measured, deferred inflows of resources relating to leases should be adjusted by the same amount.

Disclosures-Qualitative

New disclosure requirements in **bold**

- General description of the nature of leasing arrangements
- **Lessee to include:**
  - **The basis, terms, and conditions on which variable payments are determined, or the existence, terms and conditions of residual value guarantees provided by lessee, either of which are not included in the measurement of lease liability**
- **Lessor to include:**
  - **The basis, terms, and conditions of any variable payments not included in measurement of the lease receivable are determined**
  - **The existence, terms, and conditions of options by the lessee to terminate the lease, or to abate payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments**
- Terms and conditions of sublease transactions (separate from lease)
- Terms and conditions of sale-leaseback transactions (separated)
- Terms and conditions of lease-leaseback transactions (netted)
- Nature and extent of leasing transactions with related parties

Disclosures-Quantitative - Lessee

- Total amount of lease assets and related accumulated amortization, disclosed separately from other capital assets, and segregated by major classes of underlying assets
- The amount of outflows of resources [expenses] recognized in the reporting period for 1) variable payments and 2) other payments such as residual value guarantees or terminations penalties, ***not previously included in the measurement of the lease liability***
- Principal and interest requirements to maturity, presented separately, for the lease liability for each of the five subsequent fiscal years and in five-year increments thereafter
- Commitments under leases before the commencement of the lease term
- Components of any loss associated with an impairment

Many of these disclosures were included under GASB 62, but only for capital leases, not including operating leases

Disclosures-Quantitative - Lessor

- The total amount of inflows of resources (for example, lease revenue, interest revenue, and any other lease-related inflows) recognized in the reporting period from leases, if that amount cannot be determined based on the amounts displayed on the face of the financial statements;

- The amount of inflows of resources recognized in the reporting period for variable and other payments not previously included in the measurement of the lease receivable, including inflows of resources related to residual value guarantees and termination penalties

Disclosures - Certain Regulated Leases

- A general description of its agreements [subject to external laws, regulations, or legal rulings, such as regulated aviation leases]
- The extent to which capital assets are subject to preferential or exclusive use by counterparties under agreements, by class of asset and counterparty
- Total amount of lease-related inflows of resources recognized in the reporting period from these agreements, if that amount cannot be determined based on the amounts displayed on the face of the financial statements
- A schedule of expected future minimum payments under these agreements for each of the subsequent five years and in five-year increments thereafter
- The amount of inflows of resources recognized in the reporting period for variable payments not included in expected future minimum payments
- The existence, terms, and conditions of options by the lessee to terminate the lease or abate lease payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments

Beginning Your Journey

Read GASB 87 → Create a GASB 87 Team → Gather lease information → Triage → Software considerations → Journal entry and disclosures → Other Considerations

Q&A

Question #1 – Exchange transaction

- A government leases land, which has a market rent of $100,000 per year, for $1 per year. Should the government apply the guidance in Statement 87 to that transaction?

Answer #1 – Exchange transaction

- No – must be exchange or exchange-like transaction

Question #2 – Control

- A city has an agreement with Pee-Wee Football of America League to exclusively use the city's football fields at its recreational facility during football season. No other parties are allowed to use the fields at any time during football season. Does this agreement represent a lease?

Question #3 – Control

- Would this answer change if Pee-Wee Football of America had top priority of the football fields but had to allow access to others wanting to use the fields for compatible activities when not used by Pee-Wee?

Answer #2 and 3 – Control

- If the lessee is the only party allowed to access and use the land, then the contract conveys control of the right to use the underlying asset (the football fields).

Question #4 – Present Service Capacity

- A developer builds and leases a building to a government. The government is required to make payments during the three-year construction period. The government does not have access to the building until a certificate of occupancy is issued at the end of the construction period. When does the lease term begin?

Answer #4 – Present Service Capacity

- The right to use the underlying asset is the right to obtain the present service capacity from its use and the right to determine the nature and manner of its use. Thus, the lease term commences when the lessee gains physical possession of the asset or attains access to use the underlying asset.

Question #5 – Optional extension periods

- A government enters into a lease that includes an optional extension period of three years, exercisable only by the lessee. The payment schedule for the optional period will be negotiated at the time the option is exercised. The lessee has an ongoing relationship with the lessor and is reasonably certain that it will exercise its option to extend. How should the lessee measure the lease liability if the payment amount for the optional period is not specified in the contract?

Question # 5– Optional extension periods

- If lease payments are indexed to CPI, payments to be included in initial measurement of lease liability should be based on CPI in effect when lease commences (thus no change in annual payments). If the lessee is reasonably certain of extension, CPI can be used to estimate payments for those periods.

Question #6 – Variable payments

- A school district leases buses, and lease payments include a fixed portion plus a variable portion based on number of miles driven. Should the variable portion be included in the lease liability if school district is reasonably certain of the minimum number of miles that will be driven based on established routes?

Answer #6 – Variable payments

- No. Paragraph 22 – any variable payments based on future performance of lessee or usage of underlying asset should not be included in measurement of lease liability (expense as obligation is incurred).

Question #7 – Implementation

- For leases that were reported as operating leases prior to the implementation of Statement 87, should a government determine what the lease asset would have been on the date of implementation if it initially had been recognized and amortized in prior periods as a lease under the provisions of Statement 87?

Answer #7 – Implementation

- No. Paragraph 94 of Statement 87 states that leases should be measured using the facts and circumstances that existed at the beginning of the period of implementation. The government is not required to estimate what the lease asset would have been if it initially had been recognized and amortized in prior periods as a lease under the provisions of Statement 87. The lease liability should be measured using the remaining lease term and discount rate as of the beginning of the earliest period restated. The right-to-use asset should be measured based on the lease liability at that date and no restatement of beginning net position would be required because the lease asset and the lease liability would be the same.

Question #8 – Lease Modifications

- A 10-year lease contract includes an option to extend the lease for 5 years if both the lessor and lessee agree. Because both parties have to agree to extend, paragraph 12 of Statement 87 refers to this as a cancellable period and, therefore, it has been excluded from the lease term. If, during the lease term, the lessor and the lessee agree to extend the contract for five years, should this be accounted for as a lease modification or as a new lease?

Answer #8 – Lease Modifications

- Because both parties have to agree to the optional five-year period, it is considered cancellable and, therefore, not subject to the lease term reassessment guidance in paragraph 15 of Statement 87. However, once the lessor and the lessee agree to exercise the option to extend, the five-year period becomes noncancellable and should be accounted for as a lease modification. Paragraph 71 of Statement 87 states that lengthening a lease term while the contract is in effect is an amendment that should be considered a lease modification, unless it is due to a reassessment of the lease term under paragraph 15.

Thank you!

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