GASB 87 - LEASES

Alaska Government Finance Officers Association

Presenters

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Today's Agenda

- Overview
- Background
- High-level Summary
- Lease Term
- Lessee Accounting
- Lessor Accounting
- Treatment under Current Financial Resources Measurement
- Additional Considerations
- Frequently Asked Questions
- Example Transactions/Scenarios
- Similarities and Differences with FASB Lease Standard
- Key Items to Communicate to Those Charged with Governance
- Implementation Considerations
- Items to Communicate to Those Charged With Governance

Overview

- Statement No. 87, *Leases*, issued in June 2017
  - GASB followed example of the FASB and IASB and adopted new accounting treatment for leases
  - Objective of Statement No. 87 was to improve accounting and financial reporting for leases by governments
- Established a "single model for lease accounting"
  - Foundational principle that leases are financings of the right to use an underlying asset

Background

- Lease accounting = popular topic among accounting standards-setters
  - The FASB and IASB started reexamination of leases in 2006
  - GASB decided to reconsider lease accounting due to:
    - Definitions of financial statement elements (including assets and liabilities) that were not in place at the time when prior lease guidance was written
    - Desire to follow the FASB and IASB’s research

High-Level Summary

- Items previously recognized as operating leases now recognized as certain lease assets and liabilities
- Distinction between capital and operating lease is eliminated
- Lease = Contract conveying the right to use another entity's nonfinancial asset as specified in the contract for a period of time in an exchange or exchange-like transaction
  - Limited number of situations in which a contract meeting this definition would not be considered a lease
  - Right to use = right to obtain the present service capacity and right to determine the nature and manner of use of the underlying asset
- Both lessees and lessors required in most circumstances to report leases on the balance sheet/statement of net position
- Required recognition of deferred outflows and inflows of resources related to leases

High-Level Summary (cont'd)

- Leases not covered by GASB 87
  - Intangible assets
    - Natural resource rights, licensing contracts
  - Biological assets
    - Timber, living plants, living animals
  - Inventory
  - Service concession arrangements
  - Leases financed with outstanding conduit debt
  - Supply contracts (power purchase agreements)
  - Short-term leases
    - Lease with a maximum possible term at commencement of 12 months or less, including any options to extend, regardless of probability of being exercised
  - Contracts that ultimately transfer ownership of asset to lessee

Lease Term

- Period during which lessee has a noncancelable right to use an underlying asset, plus:
  - Periods covered by lessee or lessor's option to extend lease (if reasonably certain)
  - Period covered by lessee or lessor's option to terminate (if reasonably certain NOT to be exercised)
- Lease term does not change unless one or more of the following occur:
  - Lessee or lessor elects to (does not elect) to exercise an option not considered (considered) reasonably certain previously
  - An event specified in the lease contract that requires an extension or termination takes place
- Periods when both parties have option to terminate without the other party's permission are cancelable periods and are excluded from the lease term

Lessee Accounting

- Financial statement impact – Lessee
  - Required to recognize a lease liability and an intangible right-to-use lease asset
    - Liability measured at present value* of payments expected to be made during the lease term, less any lease incentives
      - Liability reduced as payments made over time
      - Interest recognized as expense

      *Present value of payments should be based on interest rate charged by lessor or lessee's borrowing rate if unknown
  - Asset measured at present value of payments over lease term
    - Plus - initial/upfront payments to lessor
    - Plus – direct costs to put asset into service
    - Less – lease incentives received from lessor at beginning of term
    - Asset amortized in systematic and rational manner over the shorter of the lease term or useful life of asset

Lessee Accounting (cont'd)

- Financial statement impact – Lessee
  - The lessee should remeasure the lease liability in subsequent years if one or more of the following occurs and is expected to significantly affect the lease liability amount from a previous measurement:
    - Change in lease term*
    - Likelihood of purchase option being exercised has changed*
    - Change in the estimated payments already included in the measurement of the lease liability
    - Change in the interest rate the lessor charges the lessee (if basis for discount rate)
    - Change in likelihood a residual value guarantee being paid will occur
    - Change in contingency which is the base used of variable payments

* would also trigger an update to the discount rate used

Lessee Accounting (cont'd)

- Financial statement impact – Lessee
  - Notes to the financial statements should include:
    - Description of leasing arrangements
      - Basis, terms, any conditions related to variable payment or residual value guarantees not included in liability measurement
    - Amount of lease assets recognized
      - Lease assets by major class, disclosed separately from other capital assets
      - Related accumulated amortization should be shown separately from other capital assets
    - Schedule of future lease payments (principal and interest disclosed separately)

Lessor Accounting

- Financial statement impact – Lessor
  - Required to recognize a lease receivable and a deferred inflow of resources at commencement of lease term
    - Receivable measured at present value of payments expected to be received during the lease term, less estimated uncollectible amounts
      - Receivable should also take into account any fixed, variable or residual value guarantee payments required by the lease, as well as any lease incentives
    - Deferred inflow of resources measured at value of lease receivable plus any payments received at or before start of lease term related to future periods, less any lease incentives received at or before start of lease term
    - Receivable reduced as payments are received, recognize interest revenue. Deferred inflow of resources – recognize revenue in a systematic and rational manner over the term of the lease

Lessor Accounting (cont'd)

- Financial statement impact – Lessor
  - The <u>lessor should remeasure the lease receivable</u> in subsequent years if one or more of the following changes occurs and <u>is expected to significantly affect the amount of the lease receivable</u> since the previous measurement:
    - Change in lease term*
    - Change in interest rate charged to the lessee*
    - Change in contingency which is the base used for variable payments

    *would also trigger an update to the discount rate used
  - The lessor should not derecognize the asset underlying the lease
    - Lessor should continue depreciating leased asset unless the lease contract requires the lessee to return the asset in its original or enhanced condition

Lessor Accounting (cont'd)

- Financial statement impact – Lessor
  - Notes to the financial statements should include:
    - Description of leasing arrangements
      - Basis, terms, conditions related to variable payments not included in the lease measurement
    - Total amount of lease revenue for current year (lease related + interest + variable lease payments/any other lease related revenue)
    - Termination or abatement provisions available as lessee options

Treatment under Current Financial Resources Measurement (Governmental Funds)

- Lessee
  - Expenditure and other financing source reported in year lease originally recognized
  - Lease payments made over term of lease = debt service expenditures
- Lessor
  - Recognize lease receivable at present value of lease payment and a deferred inflow of resources equal to the lease receivable plus any amounts received prior to the lease term related to future periods
  - Lease payments received over term of the lease – reduce receivable, record interest revenue
  - Deferred inflows of resources recognized as revenue over the term of the lease

Additional Considerations

- Contracts with multiple components
  - Lease and nonlease contract components should be treated as separate contracts
  - Leases with multiple underlying assets:
    - Each underlying asset should be accounted for as a separate lease contract
    - The allocation of the contract price between assets should be based on prices for individual components provided they don't appear unreasonable based on professional judgment
      - If individual pricing information is not available (or appears unreasonable) professional judgment of a best estimate should be applied

Additional Considerations (cont’d)

- Contracts with Contract Combinations
  - Can combine if entered into at or near the same time with same counterparty, and were either negotiated as a common package or consideration for one contract depends on price or performance of another
  - Treat such contracts as a contract with multiple components

Additional Considerations (cont’d)

- Lease Modifications
  - Amendments to a lease contract are lease modifications unless the lessee’s right to use the underlying asset decreases (then considered a partial or full lease termination)
    - Options exercised to extend or terminate the lease should be remeasured
  - Modifications to a lease contract should be treated as a separate lease if the modification adds assets to the original lease contract and the increase in payments terms are not considered unreasonable
    - If no assets added or payment terms are considered unreasonable, then remeasurement should take place
  - Remeasurement
    - Lessee – remeasure lease liability, adjust lease asset for difference before and after modification
    - Lessor – remeasure lease receivable, adjust deferred inflow for differences before and after modification

Additional Considerations (cont'd)

- Subleases
  - Should be treated as separate transactions from the original lease
- Sale-leaseback
  - Sale and lease portions should be accounted for as separate transactions
  - Any difference between the carrying value of the capital asset sold and the net proceeds from the sale should be reported as a deferred inflow or outflow of resources and recognized over the term of the lease
- Lease-leaseback
  - Should be accounted for as a net transaction
  - Gross amounts of each transaction should be disclosed

Additional Considerations (cont'd)

- Impairments
  - Guidance found in GASB 42 regarding impairment indicators still applicable
  - A change in the manner or duration of the use of a lease asset may indicate impairment
  - For impaired lease assets, asset value should be reduced for any change in the corresponding lease liability
    - Any remaining amount should be recognized as an impairment

Frequently Asked Questions

- Leases below market value
  - Leases occurring at below-market prices (e.g. a school leases a gym for $1) are not considered exchange or exchange-like transactions (GASB 33) and are not covered under GASB 87
- Easements
  - Only included under GASB 87 if the easement meets the lease definition and is for a period of time in an exchange or exchange-like transaction (very rare for an easement)
- Leases of investment properties
  - A property classified as an investment that is leased to a third party (e.g. a building held by a government as an investment) is not covered under GASB 87 (GASB 87 excludes investments)

Frequently Asked Questions (cont'd)

- Leases of multiple, similar items
  - If a government has many similar leases (e.g. copiers, computers) it may choose to amortize the lease assets as a group rather than individually
- Leases with transfer of ownership
  - Contracts transferring ownership of the underlying asset to the lessee at the end of the contract should not be accounted for as leases, but rather a financed purchase
- Subleases
  - Subleases involve three parties: original lessor, original lessee (sublease lessor) and the new lessee
  - Original lessor – applies standard lessor guidance
  - Original lessee – accounts for original lease and sublease as two separate transactions (transactions are not offsetting)
  - New lessee – applies standard lessee guidance

Example Transactions

- Lessee:
  - City of Springfield, USA has an operating lease for a storage facility with the City of Shelbyville, USA.
    - Lease is for 5 years, total of $375,000 ($75,000/year)
    - Implied interest rate of the lease is 3%
  - How would this transaction be recorded?

Example Transactions (cont'd)

- Lessee (economic resources measurement focus – Government wide):
  - Step 1- calculate present value of payment over lease term :
    - Debit – intangible right-to-use lease asset = $343,475
    - Credit – lease liability = $343,475
  - Step 2 – calculate annual lease entry:
    - Debit – lease liability = $68,695
    - Debit – interest expense = $6,305
    - Credit - cash = $75,000
    - Debit – amortization expense = $68,695
    - Credit – lease asset = $68,695
- Lessee (current economic resources measurement focus – Fund Level):
  - Step 1- calculate present value of payment over lease term:
    - Debit – expenditure = $343,475
    - Credit – other financing sources = $343,475

Example Transactions (cont'd)

Lessee (current economic resources measurement focus – Fund Level):

- Step 2 – calculate annual lease entry:
  - Debit – debt service expense – principal - $68,695
  - Debit – debt service expense – interest - $6,305
  - Credit – cash - $75,000
- Lessor:
  - Springfield School District leases a storage facility to the Krusty Burger, Inc.
    - Lease is for 5 years, total of $375,000 ($75,000/year)
    - Implied interest rate of the lease is 3%
  - How would this transaction be recorded?

Example Transactions (cont'd)

- Lessor (all funds/statements):
  - Step 1- calculate present value of lease receipts over lease term:
    - Debit – lease receivable = $343,475
    - Credit – deferred inflow of resources = $343,475
  - Step 2 – calculate annual lease entry:
    - Credit – lease receivable = $68,695
    - Credit – interest revenue = $6,305
    - Debit – cash = $75,000
    - Debit – deferred inflow of resources = $68,695
    - Credit – lease revenue = $68,695

Scenario #1

- Springfield School District leases construction equipment. The original lease term is from January 1, 2020 to June 30, 2020. The District has the option to extend the lease through December 31, 2020, and a separate option to extend the lease until December 31, 2021. The District is reasonably certain that the first option (extend through December 31, 2020) will be exercised; however, is very skeptical that the second option will be exercised. Given this information, can the District account for the lease as short-term and exclude from reporting under GASB 87?
  a) No, the lease is considered long-term since the District is reasonably certain that the first option to extend through December 31, 2020 will be exercised
  b) Yes, the only required lease term is 6 months. The others are optional and haven't been exercised
  c) No, the maximum possible term is 2 years. The probability of whether one or both options will be exercised is irrelevant
  d) Yes, the District is skeptical that the second option will be exercised

Scenario #1 (cont'd)

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  b) Yes, the only required lease term is 6 months. The others are optional and haven't been exercised
  c) No, the maximum possible term is 2 years. The probability of whether one or both options will be exercised is irrelevant
  d) Yes, the District is skeptical that the second option will be exercised.

Scenario #1 (cont'd)

Paragraph 16 – A short-term lease is a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised.

Scenario #2

- On June 21, 2020, the City of Springfield signed a lease agreement with Duff Brewing Company to lease a storage facility. The lease is for 5 years, at $800,000 per year, with an option for the City to extend the lease for another 5 years at the same rate per year. During original negotiations, the City expressed their interest to lease the storage facility for the full 10 years (but wanted the option to exit after 5 years if necessary). In 2024 the City wrote a letter to Duff Brewing exercising the 5 year extension. Does this action trigger a change in the lease term?
  a) Yes since the lease was extended in length
  b) No, the City was reasonably certain to exercise the option
  c) Yes, the exercise of any option automatically changes the lease term
  d) No, since the optional extension was included in the original lease agreement

Scenario #2 (cont'd)

- On June 21, 2020, the City of Springfield signed a lease agreement with Duff Brewing Company to lease a storage facility. The lease is for 5 years, at $800,000 per year, with an option for the City to extend the lease for another 5 years at the same rate per year. During original negotiations, the City expressed their interest to lease the storage facility for the full 10 years (but wanted the option to exit after 5 years if necessary). In 2024 the City wrote a letter to Duff Brewing exercising the 5 year extension. Does this action trigger a change in the lease term?
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  b) No, the City was reasonably certain to exercise the option
  c) Yes, the exercise of any option automatically changes the lease term
  d) No, since the optional extension was included in the original lease agreement

  Paragraph 12 – lease term is the period a lessee has a noncancelable right to use an asset plus periods covered by a lessee's option to extend if reasonably certain lessee will exercise the option

Similarities and Differences with FASB Leases Standard

- FASB issues ASU 2016-02, *Leases* (Topic 842) in 2016
  - Similarities
    - All leases are recorded on the balance sheet
    - Lessees recognize a right-to-use asset and lease liability
    - Short-term leases (maximum duration 12 months or less) are excluded from guidance
    - Intangible assets, biological assets, inventory, service concession arrangements are excluded from guidance

Similarities and Differences with FASB Leases Standard (cont'd)

- Differences
  - Types of leases
    - FASB requires lessees to differentiate between financing and operating leases; lessors differentiate between sales-type, direct financing or operating
      - Note – ASU 2016-02 reclassifies capital leases as financing leases
  - Balance sheet reporting
    - FASB requires operating leases be reported as long-term operating payables, whereas GASB classifies all lease liabilities as long-term debt

Similarities and Differences with FASB Leases Standard (cont'd)

- Differences
  - Income statement reporting
    - FASB operating leases only report one expense item (lease cost), whereas GASB requires separate reporting of interest expense and amortization expense for all leases
  - Statement of cash flows reporting
    - FASB – operating lease payments reported as operating activities; for financing leases, principal payments reported as financing, interest payments reported as operating
    - GASB – all lease payments reported as capital financing
  - Implementation
    - FASB requires adoption of lease standard using the modified retrospective transition method, whereas GASB requires retroactive implementation of new standard and restating of all prior periods presented, if applicable

Implementation Considerations

- Effective date – reporting periods beginning after December 15, 2019
  - December 31, 2020 and June 30, 2021 fiscal year ends
  - Early application is encouraged
- Restate opening balances in year of implementation
  - However, lessors should not restate the assets underlying their existing sales-type or direct financing leases
    - Any residual assets for those leases become the carrying values of the underlying assets

Implementation Considerations (cont'd)

- Client action items
  - Complete inventory of lease agreements (both as lessee and lessor)
  - Evaluation of leases
    - Lease term, components, modifications, etc.
  - Compiling of data
    - Description of leasing arrangements, terms and conditions, payment schedules, description of underlying assets, etc.
  - Lease calculations
  - Creation of general ledger accounts
  - Note disclosure preparation

Key Items to Communicate to Those Charged with Governance

- Lessee perspective:
  - Greater transparency of leasing activity and commitments
    - Substantially all leases are now accounted for on the balance sheet
    - Financing costs (interest) associated with leases (real or implied) now differentiated, shown separately
  - Expansion of balance sheet
    - Required to recognize lease assets and lease liabilities
      - No longer limited to capital leases
      - Lease liabilities considered long-term debt
  - Debt covenant implications
    - Material changes possible given addition of assets, liabilities

Key Items to Communicate to Those Charged with Governance (cont’d)

- Lessor perspective:
  - New category of deferred inflow of resources
  - Interest portion of lease receivables recognized separately
  - Assets held for investment purposes excluded from guidance

Questions?