GASB 87: A New Age of Leasing

Grand Valley School Business Officials
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Session Outline
• Existing GAAP for leases
• Leases
• Developing a plan for implementation
• Other observations
• Practical steps to implementation
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Existing GAAP for Leases

• Classification of leases (lessee perspective)
  – Capital leases (meet one of four criteria)
    1. Transfer of ownership at conclusion
    2. Bargain purchase option
    3. Lease term ≥ 75% of economic life of asset
    4. PV of future minimum lease payments ≥ 90% of FMV
  – Operating leases (all other leases)

• Accounting for leases (lessee perspective)
  – Capital leases
    • Debit capital assets and credit long-term debt for PV
    • Disclose future minimum payments
  – Operating leases
    • Expense payments as made *
    • Disclose future minimum payments (if noncancelable)
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Leases

- Key provisions
  - Single model for lease accounting
  - Foundational principle: leases are *financements* of the *right to use* an underlying asset
  - Lessees recognize a lease liability and an intangible right-to-use lease asset

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Leases

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

• Nonfinancial assets
  – Assets that are not “financial assets”, as defined by GASB 72, *Fair Value*
  – Examples: land, buildings, vehicles, and equipment

• Lease
  – Includes contracts not explicitly defined as “leases” but that otherwise meet the definition
  – Excludes contracts for services (except those contracts that contain *both* a lease component and a service component)
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• Excluded from the scope of this statement
  – Leases of intangible assets (e.g., mineral rights, movie rights, computer software licenses)
  – Leases of biological assets (e.g., timber, animals)
  – Leases of inventory
  – Service concession arrangements
  – Conduit debt arrangements
  – Supply contracts (e.g., purchased power)

• Lease term
  – Period during which a lessee has a noncancelable right to use an underlying asset
  – Plus:
    • Periods covered by either the lessee’s or lessor’s option to extend (if reasonably certain to be exercised)
    • Periods covered by either the lessee’s or lessor’s option to terminate (if reasonably certain not to be exercised)
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• Lease term
  – Periods for which both the lessee and the lessor have an option to terminate the lease (or if both parties have to agree to extend) are cancelable periods and are excluded from the lease term
  • Examples: rolling month-to-month leases

• Lease term
  – Fiscal funding or cancelation clauses only should affect the lease term when it is reasonably certain they will be exercised
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• Lease term
  – At the beginning of a lease, the lessor and the lessee should assess all factors relevant to the likelihood that the lessee or the lessor will exercise options
    • Examples: economic incentives/disincentives; lessee’s history of exercising similar options; how essential the underlying asset is to the provision of governmental services

• Reassess the term only if:
  • Lessee or lessor exercises an option not expected
  • Lessee or lessor fails to exercise an option expected
  • An event specified in the contract that requires an extension or termination of the lease actually occurs
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• Short-term leases
  – If the maximum possible lease term is 12 months or less at inception:
    • Recognize expense (lessees) or revenue (lessors) in accordance with lease contract
    • No intangible lease asset or lease liability
  – For rolling (month-to-month/year-to-year) leases, the maximum possible lease term is the noncancelable portion (including notice period)

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• Contracts that transfer ownership
  – Transfer ownership of the underlying asset to the lessee at or before the end of the contract; and
  – Do not contain termination options (other than fiscal funding or cancelation clauses not reasonably certain of being exercised)
  – Report as a finance purchase, rather than as a lease
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• Lessee recognition and measurement (lessee)
  – Lease liability
  – Intangible right-to-use asset (‘lease asset’)

• Lease liability (lessee)
  – Present value of payments expected to be made for the lease term
    • Fixed payments
    • Variable payments (dependent on index/rate) using current rates at inception
    • Amounts that are reasonably certain of being paid (e.g., residual value guarantees, purchase options, termination penalties)
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• Lease liability (lessee)
  – Present value of payments expected to be made for the lease term
    • Discounted at the rate the lessor charges the lessee (implicit rate), or the lessee’s incremental borrowing rate (if the implicit rate is not readily determinable)
    • In future periods, recognize an outflow (e.g., interest expense) for the amortization of the discount

• Lease asset (lessee)
  – Initially measured the same as the lease liability
  – Add: lease payments made to lessor at or before the beginning of the lease term; initial direct costs necessary to place the lease asset into service
  – Deduct: lease incentives received from the lessor
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• Lease asset (lessee)
  – Amortized (i.e., depreciated) in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset
  • If the lease includes a purchase option that is reasonably certain of being exercised, then amortize over the useful life of the asset (unless the underlying asset is nondepreciable, then do not amortize)

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• Accounting in governmental funds (lessee)
  – Inception: debit expenditure (capital outlay); credit other financing source (proceeds from long-term debt)
  – Lease payments: debit expenditure (debt service); credit cash
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• Notes to financial statements (lessee)
  — Disclose:
    • General description (basis, terms, conditions)
    • Total lease assets and accumulated depreciation (separate from other capital assets)
    • Amount of lease assets by major class of underlying assets (separate from other capital assets)
    • Any current year outflows (expenses) for variable payments not previously included in the lease liability

— Notes to financial statements (lessee)
  — Disclose:
    • Any current year outflows (expenses) for other payments not previously included in the lease liability
    • Principal and interest requirements to maturity (presented separately) for the lease liability for the first 5 years and in 5-year increments thereafter
    • Commitments under leases that have not yet begun
    • Components of any current year impairment loss
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Developing a Plan for Implementation

• Determine an implementation timeline
  – Effective date is FYE 06/30/2021
  – Earlier implementation is encouraged

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Developing a Plan for Implementation

• Identify the information gatekeepers
  – Finance
  – Legal
  – Other departments

• Look for existing agreements not currently being recognized/disclosed as leases
  – May already be included in capital assets
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Other Observations

• This standard will largely have a balance sheet impact
  – Lessees: offsetting asset and liability on Government-wide balance sheet
• There will likely be no significant impact on budgetary accounting

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Other Observations

• Never forget the 12 most important words of any GASB Statement:

  The provisions of this Statement need not be applied to immaterial items.

• Capitalization thresholds could (should?) be set and applied to leases, as well
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Other Observations

• Negotiating lease terms
  – Consider making the terms more obvious/explicit in the lease contract
    • Length of agreement
    • Interest rate applied

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Other Observations

• Leases are multi-year contracts with implications on future budget periods
  – The information that will have to be gathered in order to implement this standard is probably worth knowing, even for managerial purposes
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Practical Steps to Implementation

• Assess all leases > 12 months
• Contact legal/contract department
  – Explain new terms for accounting purposes
  – Operating – same
    • Month-to-month
    • Less than 12 month term

• Review capitalization threshold

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Practical Steps to Implementation

• Former operating leases
  – Record on general ledger
  – Review in conjunction with debt during audit
  – Disclose details in the notes to the F/S
    • Develop schedule
    • Update annually
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Example: Bus Lease (Governmental)

• Determine total payment amount and lease term
  – $350,000 over 5 years

• Calculate present value
  – $325,000 principal, $25,000 interest

• Calculation at inception
  Capital outlay 325,000
  Other financing source 325,000
  Lease Asset – GW entry 325,000
  Lease Obligation Payable – GW Entry 325,000

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Example: Bus Lease (Governmental)

• Annual entry – for payments made
  Debt service - principal 65,000
  Debt service - interest 5,000
  Cash 70,000

• Government-wide annual entry
  Lease Amortization 65,000
  Accumulated Amortization 65,000
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Example: Copiers/Computer Equipment

• Review/update your capitalization threshold policy
• Determine if this is an area that you would normally capitalize
  – If yes, follow previous examples
  – If no, expense annually

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Example: Land and Buildings

• Land
  – No depreciation if purchase option is expected to be exercised; otherwise depreciate over lease term
• Buildings
  – Asset capitalized should only reflect that portion of the building’s useful life that you will be leasing
  – Depending on the length of the lease, the depreciable life may be significantly less than the true useful life of the underlying asset