GASB 87 - Leases

The following information is intended to provide clarity on the impact and implementation of GASB Pronouncement No. 87

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Introduction

<u>Summary</u>

GASB-87 will replace the current operating and capital lease categories with a single model for lease accounting based on the concept that leases are a means to finance the right to use an asset. Under the new rules, the City will recognize a lease liability and an intangible asset for all noncancelable leases greater than one year while the lessor will recognize a lease receivable and a deferred inflow of resources. The intangible asset will have similar characteristics to other capital assets and may be amortized depending on various provisions of the asset (or the lease) and if need be, may be impaired.

The accounting for a lessor is complimentary. A lease receivable is established at contract inception equal to the present value of the expected payments over the lease term. As payments are received the lease receivable is reduced and interest revenue is recognized. A deferred inflow is recorded equal to the lease receivable and any payments that are made at the beginning of the lease.

Introduction

Transition

- Apply retroactively
- Restate all periods presented if practical.
- Leases recognized and measured using the facts and circumstances that exist at the beginning of the period of implementation (hindsight)
- Lessors should not restate the assets underlying their existing sales-type or direct financing leases. Any residual assets for those leases would become the carrying values of the underlying assets
- Effective For fiscal years beginning after June 15, 2021, First year will be 6/30/2022 (Cut and Shoot?)

Prior Accounting Treatment

- How were leases treated before GASB 87?

Historically governments have followed the guidance in FASB 13, Accounting for Leases. Lease classifications (i.e., operating or capital) were based on bright-line criteria which included:

- The leased period of an asset for more than 75% of its economic life.
- There is a bargain purchase option where the lessee can buy the asset at the end of the lease for less than fair market value
- Present Value of the lease payments is at least 90% of the fair value of the asset at the inception of the lease.
- Leases that did not meet one of these criteria were classified as Operating Leases and treated as period expenses.

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GASB 87 Key Elements

- How does GASB 87 define a lease?
  - A contract that conveys control of the right to use another entity's nonfinancial asset (underlying asset) as specified by the contract for a period of time in an exchange or exchange-like transaction.
    - What is considered a contract?
      - A contract is a legally enforceable agreement that creates, defines, and governs mutual rights and obligations among its parties. A contract typically involves the transfer of goods, services, money, or a promise to transfer any of those at a future date.
    - The Government Must have control which requires both of the following:
      - the right to obtain the present service capacity from use of the underlying asset, and
      - the right to determine the nature and manner of use of the underlying asset
        - Control criteria NOT limited to contracts that convey substantially all of the present service capacity from use of the underlying asset
        - Right-to-use lease assets include rights to use underlying assets for portions of time, such as certain days each week or certain hours each day.
        - When considering its ability to determine the nature and manner of use, a government should consider the extent to which it can decide how and when to use the asset, as specified in the contract. This is often referred to as decision-making rights. If a government does not have these rights, even if the contract is called a lease, then the contract would not be subject to GASB Statement No. 87.

GASB 87 Key Elements (Continued)

- What is a nonfinancial asset?
  - It's generally anything that is not a financial asset (e.g., cash, investments, receivables). Examples of nonfinancial assets include buildings, land, vehicles, and equipment.
- What is an exchange or exchange like transaction?
  - An exchange or exchange-like transaction is **one in which each party receives and sacrifices something of approximate equal value**. A non-exchange transaction is one in which one party receives something of value without directly giving value in exchange. Example of an exchange transaction is utility service. An exchange-like transaction is permits. A nonexchange transaction example is taxes, fines, gifts, grants,
  - A government's right to use land for $1 per year, which has a market rent of $100,000 per year, does not meet the description of an exchange or exchange-like transaction because each party does not receive or give up essentially equal value or not quite equal value. This type of arrangement represents a nonexchange transaction, *e.g.*, a donation or grant, which is within the scope of Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions*, and is not within Statement 87's scope.

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GASB 87 Exclusions

- Regulated Leases
  - Leases that are subject to external laws, regulations, or legal rulings (for example, the U.S. Department of Transportation and the Federal Aviation Administration regulate aviation leases between airports and air carriers and other aeronautical users)

- Intangible Assets (mineral rights, patents, software, copyrights)
  - Intangible assets and rights to use intangible assets continue to be accounted for under GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*

- Biological Assets (Timber, Animals)

- Supply Contracts (Power and water supply contracts (GTUA, GBRA, GCWA)
  - Supply contracts, such as those that are power purchase agreements, normally convey access to the output of assets, rather than control of the right to use the underlying asset.

- Inventory
  - Leases of inventory were excluded because the use of inventory normally involves a transfer of ownership rather than a lease

- Subscription-based information technology arrangements
  - Subscription-based information technology arrangements are accounted for under GASB Statement No. 96, *Subscription-Based Information Technology Arrangements*

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GASB 87 Exclusions (Continued)

- Short-term Leases

  - Short-term is defined as a lease that, at the commencement of the lease, has a <u>maximum possible lease term of 12 months, including any options to extend regardless of their probability of being exercised</u>
  - For example: A lease with a six-month noncancelable period and an option to extend for one year that is not reasonably certain to be exercised would not be considered a short term lease.
  - Even though this lease is not expected to be extended beyond a year, it is not automatically excluded. It should still be considered and the term evaluated as discussed later.
  - Leases that do qualify to be a short-term lease will be expensed as paid with no asset or liability recorded.

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GASB 87 Exclusions (Continued)

- Contracts that transfer ownership and do not contain termination options (but may contain fiscal funding or cancellation clauses)

  - Contracts that automatically transfer ownership at the end of the lease term are considered notes payable or financed purchases.
  - A fiscal funding or cancellation clause allows governmental lessees to cancel a lease—typically on an annual basis—if the government does not appropriate funds for the lease payments. Laws and regulations often require inclusion of a fiscal funding or cancellation clause in lease agreements, even though the government, acting in good faith at lease commencement, does not intend or expect to exercise the clause. The clause would affect the lease term only when it is reasonably certain the clause will be exercised.
  - A bargain purchase option of $1 is still not considered automatic transfer and would be considered a lease.

GASB 87 Exclusions (Continued)

- Immaterial leases
  - Statement 87 does **not** include a quantitative threshold exception for lower-value leases. But if the underlying assets are insignificant—individually and in the aggregate—this statement's provisions will not.
  - A common rule of thumb will be to use the same threshold as capital assets.

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Lease Term

- Once a contract has been determined to be within the scope of GASB 87, the identification of the lease term is the first step in determining the amounts that should be recognized by the lessee for the lease liability or by the lessor for the lease receivable, respectively.

  - The lease term with the period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period), plus the following periods, if applicable:
    - Periods covered by a lessee's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option
    - Periods covered by a lessee's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option
    - Periods covered by a lessor's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessor will exercise that option

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Lease Term (Continued)

- Periods covered by a lessor's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessor will not exercise that option
- Periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party (or if both parties have to agree to extend) are cancelable periods and are excluded from the lease term. Additionally, a fiscal funding or cancellation clause should affect the lease term only if it is reasonably certain that the clause will be exercised.

Reasonably Certain: The threshold of "reasonably certain" essentially retains the threshold of "reasonably assured" in current lease guidance and will require the use of professional judgment. This is a higher threshold than "probable." Judgment will be involved and discussions with the government will be necessary.

Lease Payments

- The identification of the lease payments is the second step in determining the amount that should be recognized by the lessee for the lease liability or by the lessor for the lease receivable, respectively.

  - The measurement of the lease payments must be consistent with the lease term determined previously. Lease payments during the term include:
    - Fixed payments – Payments established at specific amounts in the lease contract for which the lessee is obligated to make
    - Variable payments that depend on an index or rate—such as the Consumer Price Index (CPI) or a market interest rate—initially measured using the index or rate as of the lease term's commencement and assumed to stay in effect throughout the lease term.
    - Variable payments that are fixed in substance
      - For instance: minimum monthly number of copies for a copier lease.
      - Minimum number of miles driven when payments are based on mileage.

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Lease Payments (Continued)

- Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees (RVG)
- The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause
- Any lease incentives receivable from the lessor
- Any other payments that are reasonably certain of being required based on an assessment of all relevant factors.

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Lease Payments (Continued)

- Exclusions
  - What is not included in the lease payments?
    - Variable payments that depend on the lessee's future performance or usage of the underlying asset do not have a baseline measurement at lease term commencement and are excluded from the initial liability, e.g., copier lease payments contingent on copier usage or rental car payments dependent on miles incurred. However, any minimum guarantee amounts or other portions of variable payments that are fixed in substance, i.e., they can be readily measured, should be included in the lease liability.
    - Non-lease service components such as maintenance, supplies, taxes, insurance, and service contracts. These are simply period expenses.

Lease Liability

- Lease Liability
  - At the commencement, a lessee recognizes a lease liability as the present value of payments expected to be made during the lease term. The present value should be calculated using the interest rate implicit in the lease.
  - If that interest rate cannot be readily determined by the lessee, the lessee may use its incremental borrowing rate (an estimate of the interest rate that would be charged for borrowing the lease payment amounts during the lease term)
  - The present value of the various components of the lease should be measured separately. For instance, the present value of the fixed monthly payments on a 60 month lease will be measured separately from the final balloon payment.
  - As payments are made, the principal portion will reduce the lease liability and the remainder coded to interest expense.

Right to Use Asset

- Right to Use Asset: At the commencement of the lease, the lessee recognizes a lease right to use asset as the sum of the following:
  - The amount of the initial measurement of the lease liability.
  - Payments made to the lessor at or before the commencement of the lease term (less any lease incentives) such as down payments, prepayments.
  - Initial direct costs that are ancillary charges necessary to place the lease asset into service.
  - The asset will be amortized in a systematic and rational manor (straight-line) for the useful life or lease term.

Remeasurement

- Remeasurement: Occasionally a reassessment of the lease will be necessary if one or more of the following occur:

  - Lessee or lessor elects to exercise an option even though originally determined that the lessee or lessor would not exercise that option.

  - Lessee or lessor elects to not exercise an option even though previously determined that the lessee or lessor would exercise that option.

  - An event specified in the contract that requires an extension, modification or termination of the lease takes place.

  - If a liability is remeasured, adjust the liability for the change. Generally, the lease liability and asset should be adjusted by the same amount.

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Disclosures

- Disclosures: Lessee
  - A lessee should disclose the following about its lease activities (which may be grouped for purposes of disclosure), other than short-term leases:
  - **A general description of its leasing arrangements**, including (1) the basis, terms and conditions on which variable payments not included in the lease liability measurement are determined and (2) the existence, terms and conditions of RVGs provided by the lessee not included in the lease liability's measurement
  - **The total amount of lease assets—and the related accumulated amortization—disclosed separately from other capital assets**
  - **The amount of lease assets by major classes of underlying assets, disclosed separately from other capital assets**
  - The amount of outflows of resources recognized in the reporting period for variable payments not previously included in the lease liability's measurement.

Lessor Accounting

- Lessor Accounting
  - Lessor accounting will mirror less accounting with the following differences:
    - A lease receivable will be recorded rather than a capital asset
    - A deferred Inflow (think deferred revenue) will be recorded rather than a lease liability.
    - Payments will result in lease income rather than interest expense.

Auditing Considerations

- Auditing Considerations:
  - Under GASB Statement No. 87, completeness of contracts is a key consideration. Governments will need to evaluate all contracts to determine whether they contain a lease. Creating an inventory of all leases is the first step for most governments in implementing the statement.
  - We will need to be aware of contracts that may not have been identified by the client. We will be providing our client with a questionnaire that will highlight the primary requirements for lease consideration.
  - Additional time working with client on their understanding of the new guidance.
  - Additional new vendors will require audit confirmations.
  - Restatements and initial calculations will take more time and manpower.

Questions?

Don’t hesitate to reach out to your BW&C audit engagement team.

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