GASB Statement No. 87

Leases

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Scope and Approach

- "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."
- All leases are financings of the right to use an underlying asset
  - Therefore, single approach applied to accounting for all leases with a few exceptions
  - Lessee recognizes a liability and a capital asset
  - Lessor recognizes a receivable and a deferred inflow of resources and continues to recognize a capital asset

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Key Components of a Lease

- Right to obtain present service capacity of underlying asset
  - Period of time does not have to be uninterrupted, but is not permanent
  - Service capacity does not necessarily mean specific assets – substitution may be allowed
- Right to determine the nature and manner of use of underlying asset

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Included In GASB 87 Definition of Leases

- Nonfinancial assets – land, buildings, equipment, etc.
- Service contracts that include a lease component
- Agreements do not have to be called leases if they meet the definition of a lease

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Excluded from GASB 87 Definition of Leases

- Nonexchange transactions (e.g., leases for $1)
- Intra-entity leases – blended component units used for financing fall into this category; also, agreements between departments
- Agreements for financial assets, biological assets, inventory, supply contracts, service contracts, service concession arrangements under GASB 60
- Leases that are primarily for investment purposes
- Leases for intangible assets – may be covered under GASB 96
- Certain leases involving conduit debt
- Permanent leases – don't meet the period of time criteria

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Lease Term

- Lessee has noncancelable right to use underlying asset plus various extensions if it is reasonably certain to add to the lease term
- Periods cancelable by either party without the permission of the other party should not be included in the lease term even if there are significant cancellation penalties
- Significant cancellation penalties may affect the lease term if only one party may cancel - would be used to evaluate reasonable certainty
- Factors to be considered when evaluating reasonably certainty when reviewing lease term options:
  - Factors may be asset-based, market-based or government specific
  - Economic incentives or disincentives
  - Historical experience
  - Essential nature of asset

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Lease Term (cont.)

- Lease terms are reassessed only if:
  - Option not exercised after initial determination that option was reasonably certain to be exercised
  - Option exercised after initial determination that option was not reasonably certain to be exercised
  - An event in the lease agreement takes place that requires an extension or termination of the lease agreement
  - Reassessment does not take place until option exercised
- ALL lease terms evaluated at implementation of GASB 87 as if new
- Effect of fiscal funding clauses
  - These are called non-appropriation clauses
  - Can be ignored unless it is reasonably certain that they will be exercised

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Contracts That Transfer Ownership

- Title transfers to lessee by end of lease term and does not contain termination clauses
- Conceptually similar to an installment purchase agreement
- Accounted for as a debt-financed purchase
- Does not include agreements with a BPO

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Short-Term Leases

- Short-term leases – maximum possible term of one year or less
  - For purposes of determining short-term leases, potential lease term includes options to extend regardless of probability that they will be exercised
  - If period of use is not consecutive, would need to add use periods to determine if it is a short-term lease
  - Periods that are cancelable by both parties are not included, even if there are significant cancellation penalties
  - A series of related one-year agreements for the same property is not a series of short-term leases if they are negotiated as a package with a single objective or the payment of one contract depends on the performance of another contract
  - Accounting is similar to operating leases

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Initial Reporting – Liability - Lessee

- Recognize lease liability – this is step 1
  - PV of payments expected to be made in lease term
  - Includes some variable payments that are fixed in substance or that can be calculated at beginning of lease based on a rate or index, but not payments based on volume of usage
  - Variable payments based on a rate or index should be based on the rate or index at the start of the lease term
  - Non-lease components should be accounted for separately
  - Estimates should be used if the exact amount is unknown even for non-lease components
  - Include lease incentives
  - Include purchase options if they are reasonably certain to be exercised
  - Include reasonably certain payments of residual value guarantees
  - Include termination penalties and other payments in certain circumstances

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Initial Reporting – Lease Asset - Lessee

- Recognize lease asset – this is step 2
  - Start with lease liability
  - Adjusted for lease payments at or before the time that the lease started (deposits, future lease payments, etc.) that are related to future periods – these are reported as separate assets (Prepaid Assets) or Deposits
  - Less lease incentives received at or before the start of the lease
  - Add initial direct costs that are ancillary charges necessary to place asset into service
  - Do not include debt issuance costs which are expensed

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Initial Reporting - Lessor

- Recognize lease receivable - this is step 1
  - PV of payments received over lease term
  - Deduct any estimated uncollectible amounts
  - Includes some variable payments that are fixed in substance or that can be calculated at beginning of lease based on a rate or index (use rate or index at beginning of lease term), but not payments based on volume of usage
  - Deduct lease incentives payable to the lessee
  - Includes certain payments of residual value guarantees that are fixed in substance
- Payments related to purchase options and lease termination penalties should be recognized when they occur
- Residual value guarantees that are not fixed should be recognized as a receivable and deferred inflow of resources if a payment is required and the amount can be reasonably estimated

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Initial Reporting – Lessor (cont.)

- Recognize deferred inflow of resources – this is step 2
  - Start with the initial measurement of the lease receivable
  - Adjusted for lease payments at or before the start of the lease (deposits, future lease payments, etc.) related to future periods
  - Less lease incentives paid at or before start of lease
- Lessor should not derecognize asset underlying the lease
  - Accounting for depreciation and impairments continue
  - If asset must be returned in original condition, do not depreciate
- Initial direct costs (e.g., administrative set-up costs) are reported as outflows (expenses)

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Subsequent Reporting - Lessee

- Lease asset amortized in a systematic and rational manner
  - Shorter of lease term or underlying life of asset
  - Can use any amortization method – straight-line will be most common
  - Reported as amortization expense or may be combined with depreciation expense
  - If lease contains purchase option that lessee is reasonably certain to exercise:
    - Amortize over useful life of asset
    - For non-depreciable assets, no lease amortization
- Lease assets may also be impaired if use of lease asset is limited – follow GASB 42

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Subsequent Reporting – Lessee (cont.)

- Discount on present value is amortized in a systematic way as an outflow of resources (interest expense)
  - Interest method is used – straight-line is not an option
  - Payments are allocated to principal and then interest

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Subsequent Reporting - Lessor

- Discount on receivable amortized as interest revenue at a constant periodic rate of return (interest method – no use of straight-line) – payments allocated to interest first and then the lease receivable
- Deferred inflows of resources recognized as inflows of resources (revenues) over lease term in a systematic and rational manner
- Depreciation of asset continues (if applicable) and impairments recognized (if necessary)
- Asset should not be de-recognized until the purchase option is recognized

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Governmental Funds

- Governmental Fund accounting – current financial resources measurement focus
  - Similar entries to current GAAP
  - Remember budgetary implications
- Lessees
  - Expenditure and other financing source recognized at present value of lease payments in period that lease is initially recognized
  - Expenditures for debt service payments consistent with debt service payments on other long-term debt

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Governmental Funds (cont.)

- Lessors
  - Recognize a lease receivable and a deferred inflow of resources
  - Deferred inflow of resources would be the initial value of the lease receivable plus any payments received at or before the start of the lease related to future periods
  - Deferred inflows of resources recognized as inflows of resources in a systematic and rational manner over the lease term

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Discount Rate

- Interest rate the lessor charges the lessee – must look for this first
  - Implicit rate in the lease
  - Lessees not required to impute an interest rate per GASB 62, but may use this guidance – this option applies only to imputing an interest rate
  - Fair value of asset(s) can be used to impute a discount rate
- If lessor's rate can not be readily determined – lessee's incremental borrowing rate may be used
  - Lessee's rate to borrow a similar amount
  - Look at lease term
  - Will vary between governments based on credit ratings, lease term, type of asset, etc.
  - Affected by market interest rates

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Discount Rate (cont.)

- Remeasurement of lease liability requires a reassessment of the discount rate if there is a change in the lease term or the likelihood of a purchase option has changed from reasonably certain to not reasonably certain and vice versa
- Separate lease components would have separate discount rates

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Discount Rate - Lessor

- Discount rate is the rate the lessor charges the lessee
  - May not be the stated rate in the lease
  - Use of GASB 62 provisions for imputing an interest rate are optional
- Discount rate should be changed for remeasurement if:
  - There is a change in the lease term
  - There is a change in the interest rate the lessor charges the lessee
- The lease receivable should be remeasured using the revised discount rate in the event of a change in the discount rate

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GASB 62 Provisions

- Stated or coupon rate may be different than the prevailing market rate for similar agreements, may be unreasonable, or may not be stated at all
- Rate may be imputed from difference between cash price / fair value and actual lease payments
- Rate may be estimated from similar financings
- No set rate – based on situation
- Example in IG requires significant individual analysis

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Imputing Interest Rate Example

- Lease amount - $249,839
- Lease term(s) – 36, 60 months
- Lease options – BPO, FMV
- BPO 36-month lease payment - $7,714
- FMV 36-month lease payment - $7,258
- BPO 60-month lease payment - $4,903
- FMV 60-month lease payment - $4,751

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Imputing Interest Rate Example (cont.)

- BPO 36-month lease payment – IRR = 7.0%
- BPO 36-month lease payment – XIRR = 7.24%
- BPO 60-month lease payment – IRR = 6.625%
- BPO 36-month lease payment – XIRR = 6.83%
- These equal the implicit rates in the lease
- FMV is unknown, but can be estimated using PV and FV
- Finance rates are high compared to tax-exempt rates
- Many of these calculations are custom calculations involving many assumptions

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Calculation Background

- Must convert annual rates to actual payment schedule (monthly – divide by 12, quarterly - divide by 4)
- IRR and XIRR give different results – IRR is less accurate for periods of less than one year and interim payments
- It makes a difference whether the payment is upfront or in arrears
- 2019 Lease IG has a good illustration – B1

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Lease Incentives

- Payments made to or on behalf of the lessee which offset the obligation to the lessor or are other concessions granted to the lessee
- Includes lease payment reductions, lease holidays, reductions in lessee payment costs, etc.
- Lease incentives at or before the start of a lease reduce the value of the lease asset
- Lease incentives after the start of the lease have the effect of reducing the lease payments and the initial lease liability for the lessee and the lease receivable for the lessor
- Variable or contingent lease incentives are not included in the initial measurement
- Improvements to property by a lessor are not considered lease incentives because they do not affect payments

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Variable Payments

- If all payments are variable:
  - Some copier and guaranteed energy savings contracts are like this
  - No lease liability and lease asset recorded
  - Note disclosure of agreement
  - If variable payments have minimum amounts, the minimum amounts should be included in the calculations and a lease liability and a lease asset would be recorded

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Cell Tower Leases

- Cell tower agreements
  - Treated the same as other agreements
  - Individual agreements will need to be reviewed – if you have seen one agreement, you have seen one agreement
  - Many agreements lease physical assets and will be accounted for as leases under GASB 87 – see Question 4.7 in 2020 IG

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Regulated Leases

- Regulated leases (airports) have special considerations
  - Most of the provisions in GASB 87 do not apply to leases covered by the FAA
    - Lessors would continue with current accounting practices
    - Additional disclosures in GASB 87 would be required
  - GASB 87 provisions do apply to non-regulated activities such as restaurants
  - Airport Council International (ACI) has issued a white paper on what it believes is in and out under GASB 87

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Nonlease Components

- Not included in calculation of lease liability
- Important to analyze leases and invoices before GASB 87 implementation to separate out nonlease components – otherwise, the entire cost is included in the lease liability
- This includes taxes, insurance, CAM, maintenance, other services
- Costs may be allocated for different components using whatever information is available and professional judgment

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Contracts with Multiple Components

- If a lease has multiple underlying assets with different lease terms, account for them as separate lease components
- If the underlying assets are in different classes of assets for disclosure purposes, account for them as separate lease components
- The use of master lease agreements does not necessarily require all of the individual assets to be accounted for as a single agreement
- GASB 87 encourages the use of estimates and professional judgment in allocating amounts among components

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Note Disclosures

- Full set of note disclosures required which are similar to capital asset disclosures - disclosures for leases are made separately from capital asset disclosures
- Extensive disclosures on the components of lease payments are also required
- General description of leasing arrangements, future leasing commitments, payments made, impairments are required
- For regulated leases, a specific set of disclosures is required
- Be sure that your accounting system can produce this information

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Other Accounting Issues

- Discretely-presented component units are treated as if they are separate parties – do not combine the receivables and payables with other receivables and payables
- Subleases are treated as if they are separate transactions
- Accrued interest is a separate liability
- Use of a property manager does not affect accounting
- Impairments may occur if the service utility of the lease asset is impaired – follow guidance in GASB 42
- For economic resources statements – calculate the current and noncurrent portions of lease liabilities using the effective interest method

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Lease Modifications

- Modifying the provisions of an existing lease (amendment) outside of the provisions in the existing agreement
- Exercising an existing option within a lease agreement is subject to the guidance for remeasurement
- If the right to use the underlying asset(s) decrease(s) – full or partial lease termination
- In some situations, a lease amendment may be accounted for as a separate lease

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Lease Modifications – Separate Lease

- Some amendments during a year are required to be accounted for as a separate lease
- Separate lease accounting required if both of the following exist:
  - One or more assets were added that were not included in the original lease contract
  - Increase in lease payments is not unreasonable (if unreasonable, it will not be considered to be a separate lease)

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Lease Modifications - Lessee

- Unless a lease amendment is treated as a separate lease
  - Remeasure lease liability in accordance with the requirements for initial measurement
  - Adjust lease asset - the adjustments are commonly the same amount
  - Lease asset value should not be less than $0 – gain or loss may be required
  - Discount rate is updated
- Lease refundings have separate accounting requirements

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Lease Modifications - Lessor

- Unless a lease amendment is treated as a separate lease
  - Remeasure lease receivable in accordance with the requirements for the initial measurement
  - Adjust deferred inflow of resources - the adjustments are commonly the same amount
  - Discount rate is updated
- Lease refundings have separate accounting requirements

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Lease Remeasurement - Lessee

- Lease remeasurements may be caused by:
  - Change in lease term
  - Change in payments included in the lease liability
  - Change in likelihood of residual value guarantee being paid
  - Change in interest rate charged by lessor if it is the discount rate
  - Change in likelihood of exercise of purchase option
  - Change in a contingency affecting the lease liability
- Remeasure lease liability and lease asset for material changes
- Update indexes or rates for variable payments for remeasurement; however, remeasurement is not required solely for a change in a rate or index used to calculate variable payments

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Lease Remeasurement – Lessee (cont.)

- Changes are likely to be the same - recorded at the time of remeasurement
- Lease asset amount should not be negative
- Remeasurement is not required solely for a change in the lessee's incremental borrowing rate or a change in a rate or index used to determine variable payments (also true for lessors)
- Discount rate is updated if there is a change in the lease term or the likelihood of a purchase option being exercised

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Lease Remeasurement - Lessor

- Lease remeasurements may be caused by:
  - A change in the lease term
  - A change in the rate the lessor charges the lessee
  - A contingency is resolved allowing variable payments to become fixed and they can be included in the lease liability
- Remeasure lease receivable and deferred inflow of resources if there are material changes
- Changes in the lease receivable and the deferred inflow of resources are likely to be the same - recorded at time of remeasurement
- Update the rate or index used for variable payments if remeasuring
- Remeasurement is not required solely for a change in the rate or index for variable payments

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Lease Remeasurement – Lessor (cont.)

- Discount rate must be re-evaluated if:
  - There is a change in the lease term
  - There is a change in the interest rate the lessor charges the lessee
- If the discount rate is updated, the lease receivable and the deferred inflow of resources should be remeasured using the revised discount rate

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Lease Terminations

- Lease amendment during the reporting period that decreases the lessee's use of the underlying asset is a full or partial lease termination (e.g., lease term is shortened or underlying assets are reduced)
- Lessee
  - Reduces carrying value of lease liability and right to use asset
  - Recognize gain or loss for difference
  - If a purchase terminates the lease, re-classify lease asset as owned asset

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Lease Terminations (cont.)

- Lessor
  - Reduces carrying value of lease receivable and deferred inflow of resources
  - Recognize gain or loss for difference
  - If purchase terminates the lease, de-recognize owned asset and include in the calculation of the gain / loss

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Materiality

- Should review capitalization thresholds - the GASB specifically discussed a separate capitalization threshold for leases
- Materiality for lease liabilities should be evaluated as well
  - May be a different and lower threshold
  - Consider materiality when lease liabilities are remeasured
- Must discuss these issues with independent auditors
- New IG question clarifies that materiality applies to groups of similar assets (library books, computers, etc.) in which materiality must be evaluated for group totals

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Implementation

- Implementation for periods beginning after 6/15/21
  - FYE 6/30/22
  - Retroactive restatement required for all prior periods presented
  - If restatement is not practicable, restate beginning net position amounts for first year presented – for NC this means restate 7/1/21 and amortize
  - Disclose the nature of the restatement and its effect

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Other Implementation Issues

- Implementation should be on the first day of the earliest fiscal year presented
- All leases should be evaluated as they stand on that day – do not look back to inception of the leases
  - Lease liability measured using remaining lease term and discount rate at beginning of implementation
  - Right-to-use asset based on lease liability at implementation
  - Lease term and extensions determined at implementation – if lessee is reasonably certain to exercise lease extension – should be included in lease term
  - Short-term leases based on remaining lease term
- Review required note disclosures – be sure that accounting system will generate this information

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Other Implementation Issues (cont.)

- For existing capital leases:
  - Recalculate new lease liability
  - Lease asset is related to new lease liability
  - Adjustments are a PPA at implementation
- For sales-type and direct financing leases
  - Do not restate assets underlying leases
  - Residual assets for those leases become the carrying values of the underlying assets
- MD&A (also includes statistical section) – per Accounting Changes ED
  - MD&A amounts should be consistent with the statements presented
  - Do not restate amounts for periods before the statements presented
  - Explanation given in MD&A with cross-reference to note disclosure in financial statements for the accounting principle change

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GASB Statement No. 96

Subscription-Based Information Technology Arrangements

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Definition of SBITA

- "Contract that conveys control of the right to use another party's information technology software…"
  - Could be alone or in combination with other tangible capital assets
- Standard based on similar guidance from Statement No. 87, *Leases*

SBITA Term

- Specified use period identified in the contract (noncancellable period)
  - Includes the period of time, if applicable, to use underlying IT assets
  - Includes option to extend periods (if reasonably expected)
  - Includes option to terminate (if NOT reasonably expected)

General Guidance

- Lessee should recognize right-to-use SBITAs as intangible assets and a corresponding subscription liability
- Liability initially measured at the PV of payments to be made throughout the term
  - Payments discounted using the interest rate charged or incremental borrowing rate if interest not implicit
  - Payments expensed over term

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General Guidance (cont.)

- Asset should be initially measured at the initial liability amount
  - Add any payments made before commencement
  - Add any capitalizable implementation costs
  - Amortize the asset over the lease term or the useful life of the underlying assets, whichever is shorter

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Other Accounting Guidance

- Preliminary project stage activities are simply expensed (research, selecting a vendor, etc.)
- Implementation stage activities should be capitalized as an addition to the asset
- Subsequent maintenance, further implementations, etc. should be expensed as incurred (with some exceptions)
- Training costs always expensed

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Other Guidance (cont.)

- If a SBITA has multiple components, each should be accounted for separately if practicable
- Short-term SBITAs (e.g., max term of one year or less) expensed as payments are made (cancellable periods can affect the period)
- Note disclosures include description, accumulated amortization, and principal/interest requirements

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Implementation

- Effective for fiscal years beginning after June 15, 2022 (FYE 6/30/23 in NC)
- Earlier application encouraged
- Assets/liabilities should be measured using the facts/circumstances that existed at the beginning of the fiscal year of Statement implementation

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