A New Lease on Life:
The GASB’s New Accounting for Leases

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GASB 8X Leases

Session Outline

• Existing GAAP for leases
• GASB’s lease project overview
• Pre-ballot draft of final statement
• Developing a plan for implementation
• Other observations
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Existing GAAP for Leases

• GASB Codification Section L20 - Leases
  – NCGA Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*
  – GASB Statement 13, *Accounting for Operating Leases with Scheduled Rent Increases*
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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)
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Existing GAAP for Leases

• Classification of leases (lesser perspective)
  – Sales-type leases
  – Direct financing leases
  – Leveraged leases
  – Operating leases
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Existing GAAP for 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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GASB’s Lease Project Overview

• 2011 – added to research agenda
• 2013 – added to current agenda
• 2014 – preliminary views issued
• 2015 – field test / public hearings
• 2016 – exposure draft issued / public hearing
• 2017 – final standard expected in June
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Pre-ballot Draft of Final Statement

• Disclaimer
  – The following slides are based on a pre-ballot draft of the Leases standard as it existed as of May 8, 2017
  – The final standard could differ from these slides
  – Obtain and review the final standard once released
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• Key provisions
  – Single model for lease accounting
  – Foundational principle: leases are financings of the right to use an underlying asset
  – Lessees recognize a lease liability and an intangible right-to-use lease asset
  – Lessors recognize a lease receivable and a deferred inflow of resources
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• 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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• Control of the right to use
  – The right to obtain the present service capacity from use of the underlying asset as specified in the contract; and
  – The right to determine the nature and manner of use of the underlying asset as specified in the contract
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• Nonfinancial assets
  – Assets that are not “financial assets”, as defined by GASB 72, *Fair Value*
  – Examples: land, buildings, vehicles, and equipment
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• 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
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• 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
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• Lease term
  – 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; \textit{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”)
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• 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
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• Remeasuring the lease liability (lessee)
  – If one or more factors are expected to significantly affect the liability:
    • Change in lease term
    • Options have changed from being reasonably certain to not reasonably certain (or vice versa)
    • Change in the rate charged
    • Amounts previously contingent become reasonably certain
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• Remeasuring the lease liability (lessee)
  – If remeasuring for another reason (as required on the prior slide), then also update for any variable components
  – A lease liability is not required to be remeasured solely for a change in an index or rate used to determine variable payments
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• Remeasuring the lease liability (lessee)
  – If remeasuring for another reason (as required on the prior slide), then also update the discount rate if one or both factors are expected to significantly affect the liability:
    • There is a change in the lease term
    • Options have changed from being reasonably certain to not reasonably certain (or vice versa)
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• Remeasuring the lease liability (lessee)
  – A lease liability is not required to be remeasured, nor is the discount rate required to be reassessed, solely for a change in the lessee’s incremental borrowing rate
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• 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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• Remeasuring the lease asset (lessee)
  – Lease assets should generally be adjusted by the same amount as lease liabilities when they are remeasured
  • Do not reduce the lease asset below zero (recognize a gain)
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• Lease asset impairments (lessee)
  – If the underlying asset is impaired (see GASB 42), then the lease asset should be adjusted accordingly
    • First offset against any changes in the lease liability
    • Then recognize an impairment
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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
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Pre-ballot Draft of Final Statement

• 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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• Notes to financial statements (lessee)
  – Disclose:
    • Sublease transactions
    • Sale-leaseback transactions
    • Lease-leaseback transactions
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• Lessee recognition and measurement (lessor)
  – Lease receivable
  – Deferred inflow of resources
  – Do not derecognize the underlying asset
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• Leases of assets that are investments (lessor)
  – If the underlying asset meets the GASB 72 definition of an investment carried at fair value, then do not record a receivable or deferred inflow
  – Disclose the terms for terminating the lease
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• Lease receivable (lessor)
  – Present value of lease payments to be received
    • Fixed payments
    • Variable payments that depend on an index/rate
    • Residual guarantee payments
    • Reduced by any provision for uncollectable amounts
    • Exclude variable payments based on lessee usage (recognized as inflows as incurred)
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• Lease receivable (lessor)
  – Present value of lease payments to be received
    • Discounted using the rate the lessor charges the lessee (implicit rate)
    • In future periods, recognize an inflow (e.g., interest revenue) for the amortization of the discount, calculated to provide a constant periodic rate of return on the receivable
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• Remeasuring the lease receivable and discount rate (lessor)
  – If one or more factors are expected to significantly affect the receivable:
    • Change in lease term
    • Change in the rate charged
    • Amounts previously contingent become reasonably certain
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• Remeasuring the lease receivable and discount rate (lessor)
  – If remeasuring for another reason (as required on the prior slide), then also update for any variable components
  – A lease receivable is not required to be remeasured solely for a change in an index or rate used to determine variable payments
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• Deferred inflow of resources (lessor)
  — Initially measured the same as the lease receivable
  — Add: lease payments received at or before the beginning of the lease term that relates to future periods (e.g., last month’s rent)
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• Deferred inflow of resources (lessor)
  – Recognized in a systematic and rational manner over the lease term
  – Generally adjusted by the same amount as the lease receivable if remeasured
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• Underlying asset (lessor)
  – Do not derecognize underlying asset
  – Continue to apply depreciation and impairment guidance during the lease term
  – If the lease requires the asset to be return the asset in its original (or enhanced) condition, then do not depreciate during the lease term
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- Accounting in governmental funds (lessor)
  - Inception: debit lease receivable; credit deferred inflow
  - Lease payments received: debit cash; credit lease receivable
  - Systematically over lease term: debit deferred inflow; credit revenue
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• Notes to financial statements (lessor)
  
  – Disclose:
    
    • General description (basis, terms, conditions)
    • Amount of inflows recognized during the year from leases
    • Lease termination provisions if the government used lease receivables as collateral
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• Notes to financial statements (lessor)
  – Disclose (if applicable):
    • Leases of assets that are investments
    • Certain regulated leases
    • Sublease transactions
    • Sale-leaseback transactions
    • Lease-leaseback transactions
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• Notes to financial statements (lessor)
  – Disclose (if leasing is the government’s principal activity):
    • Schedule of future payments included in the measurement of the lease receivable showing principal and interest for each of the next 5 years and in 5-year increments thereafter
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• Lease incentives
  – A payment made to, or on behalf of, the lessee, for which the lessee has a right of offset with its obligation to the lessor; or
  – An other concession granted to the lessee
    • Rebates, assumption of pre-existing lease obligations to a third-party, rent holidays, etc.
  – Include in the initial measurement
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• Contracts with multiple components
  — Contracts may include:
    • Both a lease and a non-lease component
    • Multiple underlying assets
  — Treat as separate contracts (use professional judgment to estimate amounts)
    • If not practical to separate components, may treat as a single lease unit
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• Contract combinations
  – If multiple contracts are entered into at or near the same time, treat as one if:
    • Negotiated as a package; or
    • Price of one contract is dependent on another
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• Lease modifications
  – Treat as a separate lease if:
    • Modification provides a separate lease asset by lengthening the lease term or adding underlying assets
    • Increase in lease payments does not appear unreasonable based on contract terms and professional judgment
  – Otherwise, remeasure lease liability/receivable
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• Lease terminations
  – Decrease in the right to use the underlying asset
  – Can be partial or full termination
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• Lease terminations (lessee)
  – Reduce carrying values of lease asset and lease liability (recognize gain/loss, if any)
  – If terminated by purchasing the asset, transfer value of the lease asset to capital assets, and increase by reduction in lease liability
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• Lease terminations (lessor)
  – Reduce carrying values of lease receivable and deferred inflow (recognize gain/loss, if any)
  – If terminated by selling the asset, derecognize the asset and include in the calculation of any gain/loss
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• Subleases
  – Treat initial lease and sublease as separate transactions
  – Apply lessee and lessor guidance, as appropriate
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• Sale-leaseback transactions
  – Treat as two separate transactions
  – Any difference between the carrying value of the sold asset and the proceeds from sale should be deferred and amortized over the lease term
  – Disclose the terms/conditions
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• Lease-leaseback transactions
  – Treat as a net lease transaction
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- Intra-entity leases
  - Leases with a blended component unit
    - The provisions of this statement do not apply
    - Report assets and debt as if they belong to the primary government
  - Leases with discretely presented component units
    - Follow the provisions of this statement
    - Separately display lease receivables/payables from other amounts due to/from the primary government
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Developing a Plan for Implementation

• Determine an implementation timeline
  – Effective date is FYE 12/31/2020
  – 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
  – Lessors: offsetting asset and deferred inflow

• There will likely be no significant impact on budgetary accounting
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Other Observations

• Leases are more complicated than I realized...
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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: Garbage Truck (Proprietary)

- Determine total payment amount and lease term
  - $300,000 over 5 years

- Calculate present value
  - $275,000 principal, $25,000 interest

- Calculation at inception
  
  | Capital asset (leased equipment) | 275,000 |
  | Long-term liability (lease payable) | 275,000 |
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Example: Garbage Truck (Proprietary)

• Annual entries

  Amortization (depreciation)  55,000
  Capital asset (leased equipment A/D)  55,000

  Long-term liability (lease payable)  55,000
  Interest expense  5,000
  Cash  60,000
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Example: Fire Truck (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
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Example: Fire Truck (Governmental)

- **Annual entry**
  
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt service - principal</td>
<td>65,000</td>
</tr>
<tr>
<td>Debt service - interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>70,000</td>
</tr>
</tbody>
</table>
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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
Questions?