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

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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 $\geq$ 75% of economic life of asset
    4. PV of future minimum lease payments $\geq$ 90% of FMV
  – Operating leases (all other leases)
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Existing GAAP for Leases

- Classification of leases (lessor 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
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)
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• 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)
• 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; 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)
• Lease liability (lessee)
  – Present value of payments expected to be made for the lease term
    • Discounted as 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
• 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)
• 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
• 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
  • If 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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• 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
Lessee recognition and measurement (lessee)
- 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
• 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
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 contact 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...

How much I thought there was to know about leases
How much it turns out there really is to know about leases
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
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
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
  
  Debt service - principal 65,000
  Debt service - interest 5,000
  Cash 70,000
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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

• 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?