GASB 87: Understanding and Implementing the New Lease Accounting Standard

Wednesday, July 24, 2019

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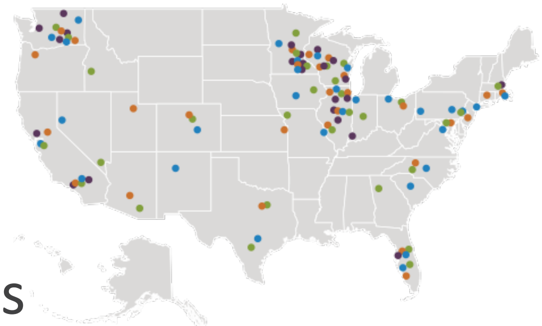

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Speaker Introductions

- **Elly Barrineau**, CPA, Managing Principal

- **Andrew Laflin**, CPA, Principal

Learning Objectives

At the end of this session you will be able to:

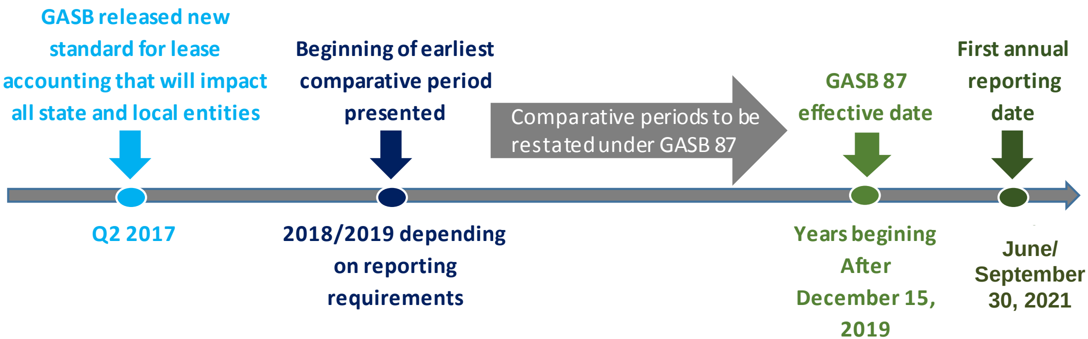
- Develop a broad recognition of the new GASB standard
- Identify the effective date for the new lease accounting standards
- Identify the presentation requirements
- Determine whether an arrangement contains a lease
- Determine some effective approaches in assessing and implementing the new standard
- Recognize both qualitative and quantitative disclosure requirements

Overview

Why change lease accounting?

- Identification of “Right to Use” asset and corresponding liability
- All leases constitute a financing transaction and will be classified as such
- Improve comparability of leasing commitments and practices across entities, industries, jurisdictions, and capital markets
- Improve disclosures for commitments
- Provide more useful information to users of financial statements through improved disclosures

Lease Standard Timeline – GASB Financial Statements



Apply requirements using the facts and circumstances that exist at the beginning of the period of implementation.

If applied to earlier periods, use the facts and circumstances that existed at the beginning of the earliest period restated.

Categories of Leases

Introduces three categories of leases:

- Short-Term Leases
  - Lease term is 12 months or less
  - Recognize expense (lessee) and revenue (lessor) based on contract provisions, as due
- Contracts that Transfer Ownership
  - Term typically longer than 12 months
  - Recognize a sale of the underlying asset (gain or loss)
- Long-term Leases
  - Longer than 12 months

Financial Statement Impact (Lessee)–Financing & Short-Term Lease

	Statement of Net Position	Statement of Activities	Statement of Cash Flows
Financing Lease	• Intangible Right-to-Use Asset (subject to GASB 42 impairment guidance) • Lease Liability	• Amortization expense • Interest expense (front loaded)	• Interest & Lease Principal = Capital & Related Financing
Short-Term Lease	N/A (unless payments are made in advance or subsequent to the reporting period)	• Lease expense • Based on payment provisions of the contract • Not straight-lined for rent holiday	• Operating

Similar to former Operating Lease treatment under GASB 13

Definition of a Lease

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.

An identified nonfinancial asset

Is explicitly or implicitly specified

+

Convey control of the right to use asset during the term

Right to obtain the present service capacity from use of the underlying asset

Right to determine the nature and manner of use of the underlying asset

Implementation Considerations

Example: Definition of Lease

Does a contract which allows the lessor to replace the underlying asset with an identical asset (substantive substitution right) affect the application of GASB 87?

Answer: Definition of Lease

No!

A lease conveys control of the *right to use* another entity's asset. That right is distinct from the underlying asset.

The right-to-use asset relates to the *service capacity* associated with an underlying asset, rather than the underlying asset itself.

Supply Contract vs. Lease

Lease?

Supply Contract?

Supply Contracts	Contracts that are intended to result in the purchase or sale of a *commodity* used in the normal course of operations.
	Normally do not convey the right to use the underlying asset.

But wait….it depends…it could be a lease

Example: Supply Contract

To obtain access to additional power during the warmest months of the year, Entity A enters into a contract with a Company B for electricity from March through October for three years.

Entity A makes fixed payments to obtain exclusive rights to the present service capacity and to determine the nature and manner of use of the turbine used to generate the electricity.

In addition, the government makes variable payments that are based on actual usage and output.

Does this contract include a lease?

Answer: Supply Contract

Yes!

While the Board stated that GASB 87 does not apply to supply contracts, this contract conveys control of the right to use the underlying asset (implicit asset = turbine) as specified in the contract for a period of time in addition to the right to the output generated by the underlying asset.

The portion of the contract that requires fixed payments pertains to the full control of the asset (assumed to be a turbine) and meets the definition of a lease.

Other Examples of Embedded Leases in Service Contracts

- Cafeteria?
- Soda fountains?
- Water coolers?
- Coffee machines?

Lease Term

The lease term is the period during which a lessee has a **noncancelable right** to use an underlying asset, plus the following periods, if applicable:

Keep in mind, these have to be reasonably certain (of being/not being) exercised, based on all relevant factors…

- Periods covered by a lessee’s option to extend the lease
- Periods covered by a lessee’s option to terminate the lease
- Periods covered by a lessor’s option to extend the lease
- Periods covered by a lessor’s option to terminate the lease

Lease Term… Keep in Mind

- Rolling month-to-month or holdover leases are cancelable if both lessee and lessor have option to terminate at any time.

- Periods where both lessee and lessor have an option to terminate without permission from the other party (or if both parties have to agree to extend) are cancelable periods and excluded from the lease term.

Example: Lease Term

A lease contract allows either party to cancel the lease at any time but also provides for cancellation penalties.

Are the cancellable periods excluded from the lease term?

Answer: Lease Term

Periods for which both the lessee **and** the lessor have an option to terminate the lease without permission from the other party have to be excluded from the lease term as cancellable periods.

The presence of cancellation penalties does not affect this conclusion.

Example: Lease Term

A lease contract allows only the lessee to cancel the lease at any time but also provides for cancellation penalties.

Are the cancellable periods excluded from the lease term?

Answer: Lease Term

Periods covered by **either** a lessee or a lessor's option to terminate the lease have to be included in the lease term if it is reasonably certain, based on all relevant factors, that the lessee or lessor will not exercise the termination option.

Lease Term: Example

Entity enters into a 12-month lease with the lessee having an option to renew for another month.

Is this agreement a short-term lease under GASB 87?

Lease Term: Example - Answer

No. The maximum possible term is required to be 12 months or less, including any options to extend.

The presence of lessee renewal options, regardless of their probability of being exercised, means this lease does not meet the definition of a short-term lease.

Leased Assets: Example

Can composite or group methods be used to amortize lease assets?

Leased Assets: Answer

Yes. If a government has many similar leases, it may choose to amortize the lease assets as a group rather than individually.

Regulated Leases: Example

An airport has a lease contract with an airline. The contract includes space for aeronautical use as well as nonaeronautical use, as defined by the Federal Aviation Administration.

How should you account for this scenario?

Regulated Leases: Example

A single contract may contain more than one lease.

While the lease of airport aeronautical space is expected to meet the criteria for treatment as a regulated lease, a lease of airport space for nonaeronautical use is not expected to meet the criteria…therefore the components should be separated in accordance with the multiple component guidance.

Service Concession Arrangements

Though a Service Concession Arrangement (SCA) is a lease-like arrangement, GASB maintains that the lease-like portion of those transactions must be addressed within consideration of the entirety of an SCA, which is specifically scoped out of Statement 87.

Instead, the accounting treatment for SCAs is specifically addressed in GASB Statement No. 60 ***Accounting and Financial Reporting for Service Concession Arrangements***

Other Contract Considerations

- Leases in which the underlying asset is financed with conduit debt (issued to finance capital assets for another entity) are excluded from this statement (unless both the underlying asset and conduit debt are reported by the lessor), due to accounting complexities as noted in GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*.

- In a continuation of guidance in *Implementation Guide No. 2015-1*, GASB explicitly excludes computer software licensing agreements from consideration in GASB 87 due to unique features and complexities of those transactions.
  - These contracts are expected to be covered in future guidance addressing information technology arrangements

Initial Direct Costs

Costs to originate a lease incurred in transactions with independent third parties that:

(a) result directly from and are essential to acquiring that lease and

(b) would not have been incurred had that leasing transaction not occurred

Certain costs directly related to specified activities performed by the lessor for that lease.

Examples:

- Evaluating the prospective lessee's financial condition
- Evaluating and recording guarantees, collateral, and other security arrangements
- Preparing & processing lease documents
- Negotiating lease terms
- Closing the transaction

Other Considerations

Discount rate

- Lessees
  - Interest rate charged by lessor, which may be an implicit rate (when determinable)
  - The lessee’s incremental borrowing rate
- Lessors – rate it charges the lessee
- Discount rates should only be reassessed in the following instances:
  - Lessee - Upon a change in the lease term or a change in determination as to whether the lessee is reasonably certain to exercise a purchase option.
  - Lessor - Upon a change in lease term or a change in interest rate charged to the lessee.

Separating Lease and Non-lease Components

Separate lease components from non-lease components (e.g., copy machine plus toner cartridges)

↓

Services are non-lease components (e.g., maintenance, CAM, utilities)

↓

Allocate the contract price based on 'reasonable' individual component prices

↓

Maximize the use of observable information in estimates, if individual prices are not available or unreasonable

↓

Only if estimating individual prices is **not practical**, may multiple component contracts be accounted for as a single lease unit

GASB: 'inconvenient' does not fall under 'not practical'!

GASB Implementation Guidance

- Exposure draft issued February 2019
- Comment period ended April 30, 2019

Note: because the new standard will be effective for periods starting after Dec. 15, 2019, entities will need to act quickly on any changes.

Process Changes

The new processes have to be documented

- Because of the absence of a uniform way of processing leases, most governments haven't followed consistent processes for requisitioning or monitoring leased property or equipment

Strong internal controls have to be in place

- All leases will become part of financial statements, which will require a different level of scrutiny
  - Scrutiny of the tracking of accounting treatment
  - Scrutiny of the processes surrounding lease management and lease lifecycles

- Need to rethink the way the governmental entity handles lease terminations, lease bookings, and lease negotiations

Process change will likely create opportunities for cost savings

Disclosures-Qualitative

New disclosure requirements in **bold**

- General description of the nature of leasing arrangements
- **Lessee to include:**
  - **The basis, terms, and conditions on which variable payments are determined, or the existence, terms and conditions of residual value guarantees provided by lessee, either of which are <u>not</u> included in the measurement of lease liability**
- **Lessor to include:**
  - **The basis, terms, and conditions of any variable payments <u>not</u> included in measurement of the lease receivable are determined**
  - **The existence, terms, and conditions of options by the lessee to terminate the lease, or to abate payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments**
- Terms and conditions of sublease transactions (separate from lease)
- Terms and conditions of sale-leaseback transactions (separated)
- Terms and conditions of lease-leaseback transactions (netted)
- Nature and extent of leasing transactions with related parties

Disclosures-Quantitative - Lessee

- Total amount of lease assets and related accumulated amortization, disclosed separately from other capital assets, and segregated by major classes of underlying assets
- The amount of outflows of resources [expenses] recognized in the reporting period for 1) variable payments and 2) other payments such as residual value guarantees or terminations penalties, ***not previously included in the measurement of the lease liability***
- Principal and interest requirements to maturity, presented separately, for the lease liability for each of the five subsequent fiscal years and in five-year increments thereafter
- Commitments under leases before the commencement of the lease term
- Components of any loss associated with an impairment

Many of these disclosures were included under GASB 62, but only for capital leases, not including operating leases

Disclosures-Quantitative - Lessor

- The total amount of inflows of resources (for example, lease revenue, interest revenue, and any other lease-related inflows) recognized in the reporting period from leases, if that amount cannot be determined based on the amounts displayed on the face of the financial statements;

- The amount of inflows of resources recognized in the reporting period for variable and other payments not previously included in the measurement of the lease receivable, including inflows of resources related to residual value guarantees and termination penalties

Disclosures - Certain Regulated Leases

- A general description of its agreements [subject to external laws, regulations, or legal rulings, such as regulated aviation leases]
- The extent to which capital assets are subject to preferential or exclusive use by counterparties under agreements, by class of asset and counterparty
- Total amount of lease-related inflows of resources recognized in the reporting period from these agreements, if that amount cannot be determined based on the amounts displayed on the face of the financial statements
- A schedule of expected future minimum payments under these agreements for each of the subsequent five years and in five-year increments thereafter
- The amount of inflows of resources recognized in the reporting period for variable payments not included in expected future minimum payments
- The existence, terms, and conditions of options by the lessee to terminate the lease or abate lease payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments

Areas of Impact

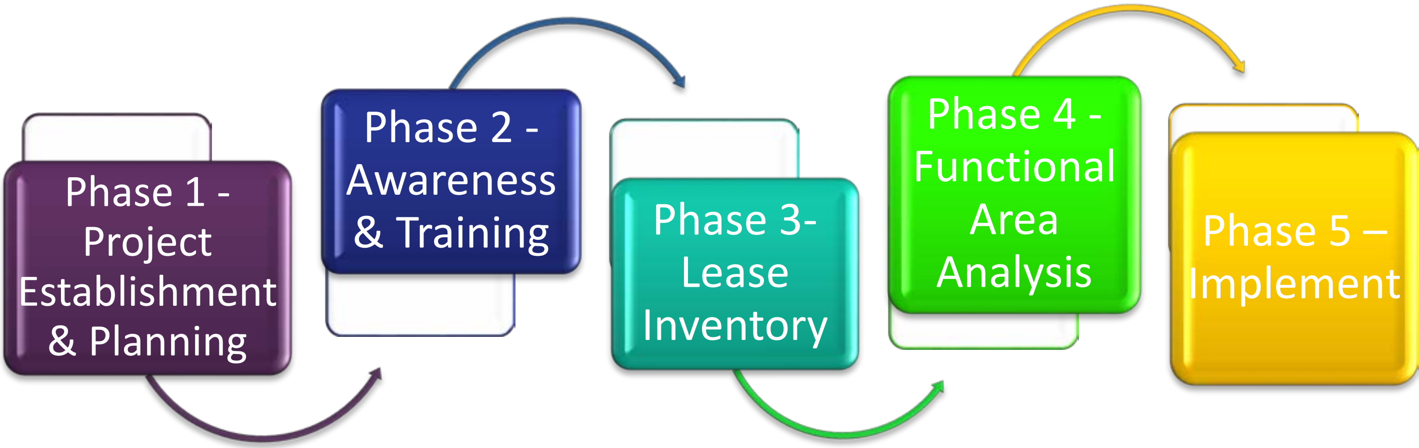
- Current business activities
- Current financial and accounting policies (e.g., capex – approval process & signature authority, accrued liabilities)
- Contract negotiations
- Budgeting and governmental fund accounting
- Financial/IT systems –future software/ application needs & processes
- Internal controls
- Key metrics

CLA Assessment and Implementation Methodology

What Now?!

- Creating an inventory of potential contracts to evaluate
- Determining which contracts meet the definition of a lease
- Review lease contracts for multiple components, such as multiple asset components and service components
- Identifying any contracts that can be excluded based on an exception or materiality
- Gathering key data from contracts in order to determine the lease term and calculate lease liability/asset or receivable/deferred inflow
- Gather data required for footnote disclosures

CLA's Approach to Assess and Implement



Phase 1 - Project Establishment & Planning

-Develop team structure critical for the success of the project:

- Establish project oversight
- Identify cross functional project team
- Identify key issues and project requirements
- Develop high-level project plan

Phase 2 - Awareness and Training

-Understand the current lease/contracts

-Identify key issues & customize the project plan:

- Develop an understanding of the current state
- Create a detailed project plan for each lease type
- Develop customized training program
- Assist in the evaluation of various lease management tools & software

Phase 3 - Lease Inventory

-Determine whether the arrangement meets the definition of a lease

-Collect the necessary data to properly account for the lease:

Utilize CLA's customized Lease Inventory Tool or software to document leases

Document process to track lease agreements

Document resolution of key issues

Develop a dual reporting process for reporting on a real-time basis under current & new GAAP

Phase 4 - Functional Area Analysis

-Define the full scope of lease convergence for successful implementation across all functional areas:

- Functional area impact assessment
- Determine “action” items versus “awareness” items
- Develop a functional area project plan
- Provide training of key aspects of guidance to functional areas

Phase 5 - Implementation Execution

-Apply the guidance to your leases & ensure compliance and timely adoption

Recommend modifications to existing accounting and reporting process

Recommend modification to accounting policies, as needed

Recommend modifications in process

The CLA Approach

- Project Manager
- Technical Oversight
- Engagement Team

Lease Management Software

- Nakisa
- PowerPlan
- LeaseQuery
- LeaseAccelerator
- UGAAP
- LeaseController


SUMMARY

5 Biggest Changes

- Operating leases are removed from lease classification; <u>all leases</u> are financings of the right-to-use an underlying asset
- Lease payments are capital financing outflows (instead of operating outflows), and lease expense will be interest on the liability and right-to-use asset amortization (instead of operating rent expense)
- Lessors will mirror lessees and recognize a lease receivable and corresponding deferred inflow of resources, while continuing to report the asset underlying the lease (distinctions of Sales-type, Direct-financing and Operating leases are removed)
- Lessor lease revenue recognized from amortizing the deferred inflow of resources
- Increased financial statement disclosures

Q&A

Question #1 – GASB 87 Leases

- A government leases land, which has a market rent of $100,000 per year, for $1 per year. Should the government apply the guidance in Statement 87 to that transaction?

Answer #1 – GASB 87 Leases

- No – must be exchange or exchange-like transaction

Question #2 – GASB 87 Leases

- Are cell phone towers or antenna placement agreements considered leases?

Answer #2 – GASB 87 Leases

- Yes, if the agreement conveys control of the right to use the land on which the tower is placed or the connection point to which the antenna is affixed

Question #3 – GASB 87 Leases

- A city has an agreement with Pee-Wee Football of America League to exclusively use the city's football fields at its recreational facility during football season. No other parties are allowed to use the fields at any time during football season. Does this agreement represent a lease?

Question #4 – GASB 87 Leases

- Would this answer change if Pee-Wee Football of America had top priority of the football fields but had to allow access to others wanting to use the fields for compatible activities when not used by Pee-Wee?

Answer #4 – GASB 87 Leases

- If the lessee is the only party allowed to access and use the land, then the contract conveys control of the right to use the underlying asset (the football fields).

Question #5 – GASB 87 Leases

- Paragraph 8f of Statement 87 states that supply contracts do not apply. What is an example of a supply contract?

Answer #5 – GASB 87 Leases

- In a supply contract, such as a power purchase agreement, government has a right to some or all of the output generated by the underlying asset, but it does not have the ability to *control* the use of the underlying asset.

Answer #5 – GASB 87 Leases

- A government enters into a contract with a private party wherein the private party will design and build a solar farm based on the government's specifications. The solar farm will be located on the government's property, but title to the solar equipment will be retained by the private party. The contract requires the government to purchase all of the power generated from the solar farm and make payments based solely on the amount of power generated. The contract also requires the private party to dismantle and remove the solar farm at the end of the contract.
- No lease of solar equipment because it is a supply contract; possible lease of land

Question #6 – GASB 87 Leases

- A developer builds and leases a building to a government. The government is required to make payments during the three-year construction period. The government does not have access to the building until a certificate of occupancy is issued at the end of the construction period. When does the lease term begin?

Answer #6 – GASB 87 Leases

- The right to use the underlying asset is the right to obtain the present service capacity from its use and the right to determine the nature and manner of its use. Thus, the lease term commences when the lessee gains physical possession of the asset or attains access to use the underlying asset.

Question #7 – GASB 87 Leases

- 5 year non-cancelable lease and after 5 years, lease is month-to-month

Answer #7 – GASB 87 Leases

- Holdover period is cancellable by either party and, therefore, is excluded from the lease term, as defined in paragraph 12 of Statement 87

Question #8 – GASB 87 Leases

- 20 year lease with option to renew the lease for an additional 5 year period

Answer #8 – GASB 87 Leases

- Paragraph 14 of Statement 87 requires that, at the commencement of the lease term, the lessee and the lessor assess all factors relevant to the likelihood that the lessee or lessor will exercise lease extension or termination options
- If the governmental lessee or lessor determines that it is reasonably certain that the option will be exercised, the lease term for the lessee or lessor would be 25 years

Question #9 – GASB 87 Leases

- A lease contract allows either party to cancel the lease at any time but also provides for cancellation penalties. Are the cancellable periods excluded from the lease term?

Answer #9 – GASB 87 Leases

- Paragraph 12 of Statement 87 requires that periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party be excluded from the lease term as cancellable periods. The presence of cancellation penalties does not affect this conclusion.

Question #10 – GASB 87 Leases

- A lease contract allows only the lessee to cancel the lease at any time but also provides for cancellation penalties. Are the cancellable periods excluded from the lease term?

Answer #10 – GASB 87 Leases

- Paragraph 12 of Statement 87 requires that periods covered by either a lessee or a lessor option to terminate the lease be included in the lease term if it is reasonably certain, based on all relevant factors, that the lessee or lessor will not exercise the option.

Question #11 – GASB 87 Leases

- A government enters into a lease that includes an optional extension period of three years, exercisable only by the lessee. The payment schedule for the optional period will be negotiated at the time the option is exercised. The lessee has an ongoing relationship with the lessor and is reasonably certain that it will exercise its option to extend. How should the lessee measure the lease liability if the payment amount for the optional period is not specified in the contract?

Answer #11 – GASB 87 Leases

- Payments may be estimated based on the lessee and lessor's ongoing relationship and professional judgment, maximizing the use of observable information

Question #12 – GASB 87 Leases

- Lease includes 3 year option period exercisable only by the lessee. Schedule for the optional period will be negotiated at the time the option is exercised. Seems relatively certain that lessee will extend. How will the lease liability be measured?

Answer #12 – GASB 87 Leases

- Include the option period in the lease liability calculation. Estimate payments based on lessee/lessor ongoing relationship and other observable information.

Question #13 – GASB 87 Leases

- 5 year lease; lease payments for first year are $5,000 per month. In subsequent years, lease payments will fluctuate based on CPI. How will the lease liability be calculated?

Question #13 – GASB 87 Leases

- If lease payments are indexed to CPI, payments to be included in initial measurement of lease liability should be based on CPI in effect when lease commences (thus no change in annual payments).
- Lease liability = PV of $5k per month over 60 months

Question #14 – GASB 87 Leases

- A school district leases buses, and lease payments include a fixed portion plus a variable portion based on number of miles driven. Include variable portion in lease liability if school district is reasonably certain of the minimum number of miles that will be driven based on established routes?

Answer #14 – GASB 87 Leases

- NO!! Paragraph 22 – any variable payments based on future performance of lessee or usage of underlying asset should not be included in measurement of lease liability (expense as obligation is incurred).

Question #15 – GASB 87 Leases

- Can a government apply a capitalization threshold for recording leased liabilities, similar to recording capital assets, including leased assets?

Answer #15 – GASB 87 Leases

- When applying a capitalization threshold to leases, lessees should consider the significance of the lease liability in addition to the significance of the leased asset. Significant lease liabilities, either individually or in the aggregate, should be recognized.

Questions?

Thank you!

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