# GASB 87 – An In-depth Dive

Leases

Cherry Bekaert LLP
CPAs & Advisors

# GASB 87

- Leases
  - Issued: June 2017
  - Effective: Effective for reporting periods beginning after June 15, 2021. Earlier application is encouraged.
- To better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments.

# Changes

**Old:**

Capital and Operating Leases

**New:**

Substantially all leases are treated as Financing Leases (Similar to Capital Lease)

# WHAT IS 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

# WHAT IS CONTROL?

Need Both:

| Right to obtain the present service capacity from the underlying asset | Right to determine the nature and manner of use of the underlying asset |
|---|---|

Contracts that fit this definition need to use lease guidance.

# NONFINANCIAL ASSETS?

Examples of Nonfinancial Assets:

| Buildings | Land | Vehicles | Equipment |
|---|---|---|---|

Any contract that meets this definition should be accounted for under the leases guidance, unless specifically excluded in the Statement.

# POP QUIZ

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# Question 1

Q – 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?

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Q – 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?

A – No. Statement 87 should be applied only to exchange or exchange-like transactions.

# Question 2

Q – A government enters into a multi-year lease of a facility. The government has exclusive use of the facility four days a week. Other parties use the facility on the other days. To meet the definition of a lease, is the government, as the lessee, required to have sole control of the right to use the facility?

# Question 2

Q – A government enters into a multi-year lease of a facility.  The government has exclusive use of the facility four days a week.  Other parties use the facility on the other days.  To meet the definition of a lease, is the government, as the lessee, required to have sole control of the right to use the facility?

A – No. Uninterrupted usage is not required for control of the underlying asset.  Right to determine nature and manner of use of the underlying asset "as specified in the contract" is sufficient to provide control.

# Question 3

Q – A contract allows the lessor to replace the underlying asset with an identical asset.  Does that substantive right of substitution affect the application of Statement 87?

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Q – A contract allows the lessor to replace the underlying asset with an identical asset.  Does that substantive right of substitution affect the application of Statement 87?

A – No.  The right to use another entity’s asset is distinct from the underlying asset itself.

# Question 4

Q – Are cell phone tower or antenna placement agreements leases?

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A – It depends.  Control criterion generally is met if a cell phone tower or antenna placement 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.

# POLLING QUESTION #1

- Is a lease present if an entity obtains the rights to the service capacity of a non-financial asset but does not have the ability or right to direct the manner of use of such an asset.
  - Yes
  - No

# Lease Terms

Non-cancelable period, plus options to:

- Extend lease, if ***reasonably certain*** to exercise
- Terminate, if reasonably certain NOT to exercise

Excludes cancelable periods:

- Periods each have the option to term
- Both parties have to agree to extend
- Rolling month to month

# Reassessment of Lease Term

Only if one of the following:

- Lessee or lessor newly elects to exercise an option
- Lessee or lessor newly elects to not exercise an option

*An event specified in contract that triggers extension or termination*

# Question 5

Q – 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?

# Question 5

Q – 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?

A – When the certificate of occupancy is issued.

# Question 6

Q – A lease contract has a noncancellable period of five years and specifies that the end of the five years, the lessor and lessee may continue the lease, using the same terms during the renegotiation period.  Is the month-to-month holdover period included in the initial assessment of the lease term?

# Question 6

Q – A lease contract has a noncancellable period of five years and specifies that the end of the five years, the lessor and lessee may continue the lease, using the same terms during the renegotiation period. Is the month-to-month holdover period included in the initial assessment of the lease term?

A – No. Periods cancellable by either party are excluded from the lease term.

# Question 7

Q – 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?

# Question 7

Q – 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?

A – Yes. The presence of cancellation penalties does not affect this conclusion.

# POLLING QUESTION #2

- If a lessee enters a 5-year lease for an option to extend the lease for 5 additional years (only the lessee has the option to decide) and is reasonably certain to pick up the option, what should the lease term be?
  - 5 Years
  - 10 Years

# Recognition and Disclosure - Lessee

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# Lessee Accounting

**Liability for PV of Future Lease Payments**

- Reduced by lease payments
- Effective interest rate

**Right of Use ASSET (Intangible)**

- Amort over shorter of useful life or lease term
- Straight-line typically

Governmental Funds – Report payables when due; no capital asset

# Question 8

Q – A government adopts a capitalization threshold and expenses acquisitions, including lease assets, that fall below that threshold.  Can the government apply a similar threshold to recording lease liabilities?

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Q – A government adopts a capitalization threshold and expenses acquisitions, including lease assets, that fall below that threshold.  Can the government apply a similar threshold to recording lease liabilities?

A – Yes (The provisions of this Statement need not be applied to immaterial items).

# Lease Liability

**The present value of payments expected to be made including:**

- Fixed payments and variable payments that are fixed in substance
- Variable payments that depend on an index or a rate
- Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees
- The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option
- Payments for penalties for terminating the lease if the lease term reflects lessee exercising option to terminate
- Any lease incentives receivable from the lessor
- Other payments that are reasonably certain of being required

# Question 9

Q – Lease payments for a five-year lease are indexed to the Consumer Price Index (CPI). The lease payments for the first year are $5,000 per month, and payments for subsequent years will increase or decrease based on the change in CPI during the preceding year. The CPI at the commencement of the lease is 251. How should the initial lease liability be calculated?

# Question 9

Q – Lease payments for a five-year lease are indexed to the Consumer Price Index (CPI). The lease payments for the first year are $5,000 per month, and payments for subsequent years will increase or decrease based on the change in CPI during the preceding year. The CPI at the commencement of the lease is 251. How should the initial lease liability be calculated?

A – Based on payments of $5,000 per month

# Recognition and Disclosure - Lessor

# Lessor Accounting

**Lease Receivable**

- Reduce by lease payments

**Deferred Inflow**

- Recognize revenue systematically

**Underlying asset remains on books**

- Depreciate as appropriate

Governmental Funds – Report lease receivable and deferred inflow of resources, recognize deferred inflow as revenue becomes available

# Summary – Initial Recognition

| | Asset | Liability | Deferred Inflow |
|---|---|---|---|
| Lessee | Intangible Asset (PV Lease Payments, Prepaids, Initial Direct Costs) | Present Value Future Lease Payments | None |
| Lessor | Lease Receivable | None | Lease Receivable, Up Front Payments |

# Summary – Subsequent Recognition

| | Asset | Liability | Deferred Inflow |
|---|---|---|---|
| Lessee | Amortized (Shorter of Useful life or Lease Term) | Reduced by payments (after interest) | None |
| Lessor | Reduced by payments | None | Amortized over lease term (straight-line) |

# Disclosure

## Lessee

- General Description
- Lease assets & accum. amort.
- Amount of Outflows
- Principal & interest
  5 years, then 5 year increments
- Commitments
- Impairment

## Lessor

- General Description
- Inflows
- Lessee’s options to term
- Future payments (if primary operation)

# Exceptions

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# Not a Lease?

| | | | |
|---|---|---|---|
| Regulated Leases (airports and air carriers) | Intra-entity leases | Short term leases | Investment assets (rental property) |
| Service concession arrangements (GASB 60) | Donated Assets | Intangible assets (software licenses, patents) | Biological assets (timber, animals, plants) |
| | Inventory | Supply contracts (power supply arrangements) | |

# Short-Term Lease

## Definition

- A lease that, at its beginning, has a maximum possible lease term of 12 months or less

## Accounting - Lessee

- Expense based on contract payment provisions

## Accounting - Lessor

- Revenue based on contract payment provisions

# Short-Term Leases

## At commencement, maximum possible term of 12 months

- Lessee – Recognize expense, no asset/liability
- Lessor – Recognize revenue, no receivable/deferred inflow
- No resource flow during rent holidays
- No required disclosure

# Question 10

Q – A government enters into a 12-month lease with the lessee having options to renew for 12 months at a time, up to 49 times. Is this agreement a short-term lease under Statement 87?

# Question 10

Q – A government enters into a 12-month lease with the lessee having options to renew for 12 months at a time, up to 49 times.  Is this agreement a short-term lease under Statement 87?

A – No.  The maximum possible term includes options to extend, regardless of their probability of being exercised.

# Question 11

Q – A government enters into a lease with a six-month noncancellable period and an option to extend for one year. The government is not reasonably certain that it will exercise the option to extend and, therefore, assesses the lease term as six months. Is this agreement a short-term lease under Statement 87?

# Question 11

Q – A government enters into a lease with a six-month noncancellable period and an option to extend for one year. The government is not reasonably certain that it will exercise the option to extend and, therefore, assesses the lease term as six months. Is this agreement a short-term lease under Statement 87?

A – No. The maximum possible term includes options to extend, regardless of their probability of being exercised.

# Question 12

Q – A city enters into a lease with a lessor for 16 months. The city can cancel the lease at any time after six months. The lessor does not have the option to cancel the lease. For purposes of determining whether this lease is a short-term lease, what is the maximum possible term for this lease?

# Question 12

Q – A city enters into a lease with a lessor for 16 months. The city can cancel the lease at any time after six months. The lessor does not have the option to cancel the lease. For purposes of determining whether this lease is a short-term lease, what is the maximum possible term for this lease?

A – 16 months. Option to cancel by **either** the lessee or lessor would reduce the maximum possible term.

# Regulated Leases

Certain leases are subject to external laws, regulations or legal rulings, and are exempt if they meet all of the following criteria:

A. Lease rates cannot exceed a reasonable amount (determined by external regulator)

B. Lease rates should be similar for lessees who are similarly situated, and

C. Lessor cannot deny a potential lessee if facilities are available

# POLLING QUESTION #3

- Does an 8-month lease for $20 Million Dollars meet the exception criteria for applying GASB 87
  - Yes
  - No

# Implementation

- Read the Standard and Implementation Guidance
- Collect information
- Analyze
- Transition
- Implement

# Transition

Apply Retroactively:

Restate, if practicable

Otherwise, restate beginning net position for cumulative effect

Facts and circumstances at beginning of period of implementation

Immaterial items may be ignored

# Example

The City of Bikini Bottom enters into a 3-year lease for the assets below. The assets are being leased from Mr. Krabs County.

- Asset 1 – Boat named “Gary” – estimated FV of $100,000
- Asset 3 – Warehouse – Estimated FV of $500,000

Annual payments are as follows for both:

- Year 1 - $20,000; Year 2 - $22,000; Year 3 - $24,000
- The City noted they previously leased a similar boat for $5,000 per year
- The City has a borrowing rate of 10%
- No transfer of ownership; no options to purchase

# Example – Multiple Component

Assume the boat lease payment schedule is: $5,000; $5,500; $6,000 (judgement)

Therefore, warehouse payments will be $15,000; $16,500; $18,000

# Example – Lessee Initial Recognition

| PV of Boat Lease Liability | | PV of Warehouse Lease Liability | |
|---|---|---|---|
| Term | | Term | |
| Payments | | Payments | |
| Rate | | Rate | |
| PV per TValue | | PV per TValue | |

| | Debit | Credit |
|---|---|---|
| ROU Boat Asset | | |
| ROU Warehouse Asset | | |
| Lease long term debt | | |

# Example – Lessee Initial Recognition

| PV of Boat Lease Liability | | PV of Warehouse Lease Liability | |
|---|---|---|---|
| Term | 3 Years | Term | 3 Years |
| Payments | $5,000; $5,500; $6,000 | Payments | $15,000; $16,500; $18,000 |
| Rate | 10% | Rate | 10% |
| PV per TValue | $13,600 | PV per TValue | $40,800 |

| | Debit | Credit |
|---|---|---|
| ROU Boat Asset | | |
| ROU Warehouse Asset | | |
| Lease long term debt | | |

# Example – Lessee Initial Recognition

| PV of Boat Lease Liability | | PV of Warehouse Lease Liability | |
|---|---|---|---|
| Term | 3 Years | Term | 3 Years |
| Payments | $5,000; $5,500; $6,000 | Payments | $15,000; $16,500; $18,000 |
| Rate | 10% | Rate | 10% |
| PV per TValue | $13,600 | PV per TValue | $40,800 |

| | Debit | Credit |
|---|---|---|
| ROU Boat Asset | $13,600 | |
| ROU Warehouse Asset | $40,800 | |
| Lease long term debt | | $54,400 |

# Example – Lessee Year 1

| Amortization | Initial Value | Useful Life | CY Amort | Accumulated Amortization | NBV |
|---|---|---|---|---|---|
| Gary Boat | | | | | |
| Warehouse | | | | | |
| | | | | | |

| Interest Expense | |
|---|---|
| Total "borrowings" | |
| Rate | |
| Interest | |

| | Debit | Credit |
|---|---|---|
| Amortization expense | | |
| Accumulated amortization – leased assets | | |
| Lease liability | | |
| Interest expense | | |
| Cash | | |

# Example – Lessee Year 1

| Amortization | Initial Value | Useful Life | CY Amort | Accumulated Amortization | NBV |
|---|---|---|---|---|---|
| Gary Boat | $13,600 | 3 | $4,533 | $4,533 | $9,067 |
| Warehouse | $40,800 | 3 | $13,600 | $13,600 | $27,200 |
| | $54,400 | | $18,133 | $18,133 | $36,267 |

| Interest Expense | |
|---|---|
| Total "borrowings" | |
| Rate | |
| Interest | |

| | Debit | Credit |
|---|---|---|
| Amortization expense | | |
| Accumulated amortization – leased assets | | |
| Lease liability | | |
| Interest expense | | |
| Cash | | |

# Example – Lessee Year 1

| Amortization | Initial Value | Useful Life | CY Amort | Accumulated Amortization | NBV |
|---|---|---|---|---|---|
| Gary Boat | $13,600 | 3 | $4,533 | $4,533 | $9,067 |
| Warehouse | $40,800 | 3 | $13,600 | $13,600 | $27,200 |
| | $54,400 | | $18,133 | $18,133 | $36,267 |

| Interest Expense | |
|---|---|
| Total “borrowings” | $54,400 |
| Rate | 10% |
| Interest | $5,440 |

| | Debit | Credit |
|---|---|---|
| Amortization expense | $18,133 | |
| Accumulated amortization – leased assets | | $18,133 |
| Lease liability | $14,560 | |
| Interest expense | $5,440 | |
| Cash | | $20,000 |

# Example – Lessor Initial Recognition

- Assume Mr. Krabs County knows City of Bikini Bottom's borrowing rate.

| | Debit | Credit |
|---|---|---|
| Lease Receivable | | |
| Deferred Inflow | | |

# Example – Lessor Initial Recognition

- Assume Mr. Krabs County knows City of Bikini Bottom's borrowing rate.

| | Debit | Credit |
|---|---|---|
| Lease Receivable | $54,400 | |
| Deferred Inflow | | $54,400 |

# Example – Lessor Year 1

| | Debit | Credit |
|---|---|---|
| Cash | | |
| Interest Income | | |
| Lease Receivable | | |
| Lease Revenue | | |
| Deferred Inflow | | |

# Example – Lessor Year 1

| | Debit | Credit |
|---|---|---|
| Cash | $20,000 | |
| Interest Income | | $5,440 |
| Lease Receivable | | $14,560 |
| Lease Revenue | | $18,133 |
| Deferred Inflow | $18,133 | |

# Implementation Guide

## Appoint a champion

- Someone to spearhead the process

## Create a task force

- Assess and implement the necessary changes

## Inventory the lease population

- Will be time consuming

# Implementation Guide

## Consider change management

- How to identify triggers for reassessment

## Communicate with stakeholders

- Manage expectations

# POLLING QUESTION #

- Are you currently analyzing your lease population for GASB 87 implementation?
  - Yes
  - No