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GASB Leases:
What You Need to Know to Implement

May 17, 2019

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General Overview

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GASB 87 Background

- Statement 87: Leases
  - Issued: June 2017
  - Effective: For reporting periods beginning after December 15, 2019
    - Early application is encouraged
- Background
  - FASB & IASB issued final standards regarding leases

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Definition

- A lease is 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
  - Substance over form
    - Includes contracts that are not identified as a lease that meet the definition of a lease

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Control

Has BOTH

The right to obtain the present service capacity from use of the underlying asset as specified in the contract	The right to determine the nature and manner of use of the underlying asset as specified in the contract

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Nonfinancial Asset

- Use Statement 72, Fair Value
  - Examples include land, buildings, vehicles and equipment

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Not in Scope

- Service contracts
  - Unless it contains both a lease and a service component
- Intangibles (including rights to explore natural resources)
- Biological assets (including timber, living animals)
- Inventory
- Service Concession Arrangements (Stmt 60)
- Leases financed with outstanding conduit debt (unless both asset and debt are reported by lessor
- Supply contracts (power purchase agreements)

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Lease Term

- Noncancelable period PLUS
  - Periods covered by a lessee's option to extend if it is *reasonably certain* that lessee will exercise option
  - Periods covered by a lessee's option to termination if it is *reasonably certain* that the lessee will NOT exercise the option
  - Period covered by lessor's option to extend if it *reasonably certain* to exercise the option
  - Period covered by lessor's option to terminate if it is *reasonably certain* that the lessor will NOT exercise that option

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Reasonably Certain

- Assess all factors – contract based, asset based, market based or government specific
  - Economic incentives (favorable terms compared to market)
  - Economic disincentive (costs to terminate, relocation costs, abandonment of leasehold improvements
  - History of exercising options
  - Extent to which asset is essential to the provision of government services

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Reassessment

- Reassess lease term only if:
  - Lessee or Lessor elects to exercise option even though it was previously determined it would not
  - Lessee of Lessor elects NOT to exercise an option even though it was previously determined It would
  - An event specified in the lease contract that requires an extension or termination takes place

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Fiscal Funding

- Fiscal funding or cancellation clause allows governmental lessees to cancel a lease if it does not have appropriate funds
  - Only consider in term if it is reasonably certain it will be exercised

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Lease Incentives

Payments made to, or on behalf of, the lessee, for which the lessee has a right of offset with its obligation to the lessor

OR

Other concessions granted to the lessee

- Reimbursements of lessee costs, rent holidays, reductions of interest or principal charges by lessor

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Lease Incentives

- Reduce the amount a lessee is required to pay
- If before lease term:
  - Included in initial measurement of lease asset
- If provided after commencement:
  - Accounted for by lessees and lessors as reductions of lease payments
  - Included in initial measurement (and any remeasurement) if fixed
  - Variable incentives are not included in initial measurement

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Short Term Leases

- A lease (at commencement) has a maximum possible term under the lease of 12 months or less INCLUDING options to extend (regardless of their probability of being exercised)
- For a rolling month-to-month lease (or year to year) the maximum possible term is the noncancelable period (including notice periods)

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Short Term - Lessee

- Recognize outflow of resources based on payment provisions
  - Asset or liability if payments made in advance or subsequent to reporting period
  - No outflow during rent holiday period

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Short Term - Lessors

- Lease payment receipts – inflows of resources
  - Liability if received in advanced or asset if received subsequent reporting period
  - No inflow during rent holidays

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Contract that Transfers Ownership

- A contract that:
  - Transfers ownership of the underlying asset to the lessee by the end of the contract
  - Does not contain a termination option
- Should be reported as a financed purchase of the underlying asset by the lessee or sale of the asset by the lessor

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Multiple Components

- Contract may contain multiple components
  - both a lease component and a non-lease component
  - or multiple underlying assets

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Lease & Non-Lease Components

- General Rule: Account for the lease and non-lease components as separate contracts

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Multiple Underlying Assets

- If multiple underlying assets and the assets have different lease terms, account for each underlying asset as a separate lease component.
- Account for each underlying asset as a separate lease component if the underlying assets are in different major classes of assets for disclosure purposes

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Allocation for Multiple Components

- Use any prices for individual components that are included in the contract
  - Exception: Unless appears to be unreasonable (based on the terms of the contract and professional judgment)
  - Maximizing the use of observable information (stand alone price)

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Exception – Price Allocation

- Exception: If a contract does not include prices for individual components, or if any of those prices appear to be unreasonable
  - Use professional judgment to determine their best estimate
  - Maximizing the use of observable information

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Discounts

- Bundle discounts
  - Discounts may be taken into account

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Exception – Multiple Components

- If it is not practicable to determine a best estimate for price allocation for some or all components in the contract, account for those components as a single lease unit.
  - Accounting for that unit should be based on the primary lease component within that unit

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At or Near Same Time

- Contracts that are entered into at or near the same time with the same counterparty should be considered part of the same contract if **either** of the following criteria is met:

The contracts are negotiated as a package with a single objective.

The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

- Treat as multiple components

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Intra-Entity

- When the lessee or lessor is included as a blended component unit of the primary government, Stmt 87 doesn't apply
  - The debt and assets of the lessor should be reported as if they were the primary government's debt and assets.
  - The debt service activity of the lessor would be reported as a debt service activity of the reporting entity.

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Intra-Entity

- For leases with or between blended component units eliminations should be made before the FS of the blended component units are aggregated with those of the primary government.
  - The remaining cash payments between component units should be reported as inflows of resources and outflows of resources

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Intra-Entity Cont'd

- Lease arrangements between the primary government and discretely presented component units (or between discretely presented component units) should be treated consistently with Stmt 87.
  - Related receivables and payables should not be combined with other amounts due to or due from discretely presented component units or with lease receivables and payables with organizations outside the reporting entity

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Related Parties

- In the separate FS of the related parties, the classification and accounting should be the same as for similar leases between unrelated parties
  - Exception: when it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related.
    - Classification and accounting should be modified as necessary to recognize the substance of the transaction rather than merely its legal form

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Related Parties Cont'd

- The nature and extent of leasing transactions with related parties should be disclosed

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Related Parties Cont'd

- In financial statements for which an interest in an investee is accounted for using the equity method, any inflow of resources or outflow of resources should be accounted for in accordance with Statements 62 and 72.

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Lessee Accounting

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Lessee Accounting

- At commencement recognize
  - Lease liability
  - Intangible right to use asset

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Lease Liability

- Fixed payments
- Variable payments that depend on an index or a rate
- Variable payments that are fixed in substance
- 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
- Any lease incentives receivable from the lessor
- Any other payments that are reasonably certain of being required based on an assessment of all relevant factors

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Do Not Include

- Variable payments based on future performance of the lessee or usage of the underlying asset
  - Expense in period incurred

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Discount Rate

- Use rate charged by lessor (may be implicit in the lease)
- If can not be readily determined use estimated incremental borrowing rate

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Subsequent Measurement

- Amortization of discount on lease liability
  - Interest expense
  - Payments should first be allocated to accrued interest and then lease liability

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Remeasurement

- General Rule – don't remeasure

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Remeasurement - Exceptions

- Change in the lease term
- Likelihood of a residual value guarantee being paid has changed from reasonably certain to not reasonably certain, or vice versa
- Likelihood of a purchase option being exercised has changed from reasonably certain to not reasonably certain, or vice versa
- Change in the estimated amounts for payments already included in the measurement of the lease liability
- Change in the interest rate the lessor charges the lessee, if used as the initial discount rate
- A contingency, upon which some or all of the variable payments that will be made over the remainder of the lease term are based, is resolved

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Remeasurement

- If liability is remeasured also adjust for changes in index or rate
  - Do not remeasure solely for these changes

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Change in Discount Rate

- General Rule – don't
- Exception – significant impact &
  - There is a change in lease term
  - Likelihood of purchase option being exercised has been changed
- If remeasured, use interest rate that the lessor charges at the time the discount is updated or incremental borrowing rate at time discount rate is updated

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Lease Asset

- Sum of:
  - Initial lease liability
  - Payments made to lessor at or before commencement (less any incentives)
  - Initial direct costs that are ancillary charges necessary to place the lease asset into service
    - Any initial direct costs that would be considered debt issuance costs should be expensed in period incurred

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Subsequent Analysis

- Amortized in systematic and rational manner over SHORTER of:
  - Lease term
  - Useful life
- Exception
  - Purchase option reasonable certain of being exercised then use useful life

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Impairment

- Presence of impairment indicators (Statement 42) may result in a change to manner or duration of use of ROA Asset

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Current Financial Resources Measurement Focus

- Follow fund accounting
  - An expenditure and other financing source should be reported initially
  - Lease payments should be consistent with debt service payments on long term debt

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Disclosures

- A general description of its leasing arrangements,
- The total amount of lease assets, and the related accumulated amortization, disclosed separately from other capital assets
- The amount of lease assets by major classes of underlying assets, disclosed separately from other capital assets
- The amount of outflows of resources recognized in the reporting period for variable payments not previously included in the measurement of the lease liability
- The amount of outflows of resources recognized in the reporting period for other payments
- 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
- The components of any loss associated with an impairment

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Lessor Accounting

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Lessor Accounting

- Recognize
  - Lease receivable
  - Deferred inflow of resources
- Initial direct costs are outflows of resources

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Scope

- If asset is an investment under Statement 72
  - Measurement doesn't apply
  - Some disclosures do
- Certain regulated leases (DOT, FAA)
  - Recognition and measurement follow provisions of lease contract
  - Special disclosures do

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Regulated Lease Disclosures

A general description of its agreements	The extent to which capital assets are subject to preferential or exclusive use by counterparties under agreements, by major class of assets and by major counterparty	The total amount of inflows of resources recognized in the reporting period from these agreements*
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.

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Regulated Lease

- External laws, regulations, or legal rulings establish ALL of the following:
  - Lease rates cannot exceed a reasonable amount (external regulator)
  - Lease rates should be similar for lessees that are similarly situated
  - Lessor cannot deny potential lessees the right to enter into leases if facilities are available, provided that the lessee's use of the facilities complies with generally applicable use restrictions

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Lease Receivable

- Present value of lease payments expected to be received during the lease term, reduced by provisions for estimated uncollectible amounts
  - Fixed payments
  - Variable payments that depend on index or rate
  - Variable payments are in substance fixed
  - Residual value guarantees that are in substance fixed
  - Lease incentives payable to lessee

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Do Not Include

- Variable payments based on future performance of the lessee or usage of the underlying asset
  - Inflows (revenue) in period to which they relate

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Contingencies

- Amounts receivable under a residual value guarantee (that are NOT fixed) are recognized into the lease receivable if
  - A guarantee payment is required
  - The amount can be reasonably estimated

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Subsequent Measurement

- Amortize discount on lease receivable
  - Inflow of resource
  - Allocate payment first to accrued interest receivable then lease receivable

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Remeasurement

- General Rule: Do not remeasure

- Exception: If one ore more of the following:
  - Change in lease term
  - Change in interest rate charged by lessor
  - A contingency is resolved and now meet the definition of a receivable

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Remeasurement

- If remeasurement is triggered also must recalculate index or rate used

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Discount Rate Update

- Update the discount rate if:
  - Change in lease term
  - Change in interest rate charged by lessor
- Receivable should be remeasured using the revised discount rate

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Deferred Inflow of Resources

- Initially measured as:
  - Initial amount of lease receivable
  - Lease payments received at or before commencement
  - Less any incentives

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Subsequent Measurement

- Recognize an inflow (revenue) in a systematic and rational matter over the lease term

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Underlying Asset

- Do not derecognize the asset
  - Continue to depreciate and impair
    - Exception: if contract requires lessee to return the asset in original or enhanced condition

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Current Financial Resources Measurement Focus

- Recognize
  - Lease receivable
  - Deferred inflow

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What Questions Do You Have?

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Facts:

The City of Everywhere enters into a contract on January 1, 2019 with a for profit entity to lease office space for City business. The lease does not transfer ownership at the end of the lease. The office space is expected to have a 20-year life.

The contract has an initial lease term of ten years with the option to extend for an additional five years. The City believes that the value of the property will increase over the next two decades and that the contractual terms will continue to be advantageous to the City. As such, they believe it is probable that they will exercise the option to extend. There is a $500 fee to exercise the extension option.

The contract indicates the office space has a lease price of $50,000 which also includes common area maintenance. The lease indicates that 10% of the lease price is for CAM. The City believes these prices to be reasonable. Rent payments are due December 31st of each year.

The rate implicit in the lease is not known to the City. Its incremental borrowing rate is 7% and the prime rate is 2%. The City must pay a commission to the real estate agent who located the buildings of $2,500.

Given:

The present value factor for an annuity at 7% for 10 years is 7.0236.

The present value factor for an annuity at 7% for 15 years is 9.1079.

The present value factor for an annuity at 2% for 10 years is 8.9826.

The present value factor for an annuity at 2% for 15 years is 12.8493.

The present value of $1 for 10 years at 7% is .5083.

The present value of $1 for 15 years at 7% .3624.

The present value of $1 for 10 years at 2% is .8203.

The present value of $1 for 15 at 2% is .7430.

Requirements: Complete the following questions (round all answers to nearest dollar)

Step 1 – Determine the lease term and explain why

Step 2 – Calculate the lease liability.

Step 3 – Calculate the value of the lease asset

Step 4 – Prepare the journal entry for December 31, 2019 asset amortization

Step 5 – Prepare the journal entry for December 31, 2019 lease payment