A Call to Action!

GASB 87—Accounting for Leases

Speakers:

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National Association of State Comptrollers
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Today’s Agenda

— Overview
  ▪ Objective of GASB 87
  ▪ Lease Definition – What’s in and What’s Out

— Transition

— Reporting Leases

— Key Concepts and Terms

— Where to Start?
Learning Objectives

— Recognize the key changes as a result of GASB 87.
— Recall the scope, scope exceptions, and definition of a lease.
— Identify the transition approach to the new standard.
— Recognize the accounting requirement for the key concepts that are applicable to both the lessee and lessor.
— Identify the challenges and next steps to begin implementation.
Objective of GASB 87

“To better meet the information needs of financial statement users by improving the accounting and financial reporting for leases; enhancing the comparability of financial statements between governments; and also enhancing the relevance, reliability (representational faithfulness), and consistency of information about the leasing activities of governments.”

Better reflects the economics of lease transactions, essentially financing transactions!
Scope – What’s in

A contract (e.g., an agreement between two or more parties that creates enforceable rights and obligations) 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.

— Definition includes:

- Subleases
- Contracts that are not specifically identified as a lease, but meet the definition of a lease
- Lease component within a contract containing multiple components

How is this definition any different than the existing definition?
Scope – What’s out

Applies to leases of all assets, including subleases, except for the following leases:

- Leases of intangible assets, including:
  - Leases to explore for or use non-regenerative resources
  - Licensing contracts for items such as motion picture films, video recordings, plays, manuscripts, patents, copyrights, and computer software
- Leases of biological assets, including timber, living plants and animals
- Leases of inventory
- Contracts that meet the definition of a service concession arrangement
- Leases with the underlying asset financed with outstanding conduit debt, unless both the underlying asset and the conduit debt are reported by the lessor
- Supply contracts, such as power purchase agreements
Transition
# Effective date

<table>
<thead>
<tr>
<th>Effective date</th>
</tr>
</thead>
</table>

*Early adoption is not only allowed, it is encouraged!*

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**Warning!** One of the biggest challenges with this new standard is implementation and the work that needs to be done before implementation can even occur.

Identifying the population of leases and gathering the necessary information for them can be both challenging and time consuming!
Transition

Retroactively applied by restating financial statements

If practicable

For all periods presented

If not practicable

Cumulative effect reported as a restatement of beginning net position for the earliest period restated

Inconvenient is not equivalent to not practicable!
Transition considerations

— Following are relevant dates for a June 30th year-end:

<table>
<thead>
<tr>
<th>Beginning of the earliest period presented</th>
<th>Effective date (date of adoption)</th>
<th>Current period</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1, 2019</td>
<td>July 1, 2020</td>
<td>June 30, 2021</td>
</tr>
</tbody>
</table>

— Other considerations:

- Use facts and circumstances that existed at the beginning of the earliest period restated, NOT the commencement date of the lease!
  - EXCEPTION: Lessors do not restate assets underlying existing sales-type or direct-financing leases. Any residual assets for those leases become the carrying values of the underlying assets.
Reporting Leases
## Three types of “leases”

<table>
<thead>
<tr>
<th>Short-term leases</th>
<th>Contracts that transfer ownership</th>
<th>All other leases</th>
</tr>
</thead>
</table>
| Maximum possible term at commencement date of 12 months or less | Defined as any contract that:  
  - Transfers ownership of the underlying asset to the lessee by the end of the contract, and  
  - Does not contain termination options  
  - These contracts are accounted for as financed purchases of the underlying asset by lessees and sales by lessors | Lease liability and lease asset are recognized |
| No recognition of lease liability or lease asset required! |  | Focus of GASB 87 |
| Short term payments are expensed as incurred by lessees and recognized as revenue by lessors |  |  |
## Initial Reporting

### All Other Leases

<table>
<thead>
<tr>
<th></th>
<th><strong>Assets</strong></th>
<th><strong>Liability</strong></th>
<th><strong>Deferred Inflow</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessee</td>
<td>Intangible asset (right to use underlying asset) plus prepayments and any ancillary costs to place asset to use</td>
<td>PV of expected payments over the lease term</td>
<td>N/A</td>
</tr>
<tr>
<td>Lessor</td>
<td>PV of expected payments over the lease term</td>
<td>N/A</td>
<td>Equals lease receivable plus any cash received up front that pertains to a future period</td>
</tr>
<tr>
<td></td>
<td>Continue to report asset</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Subsequent Reporting

### All Other Leases

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liability</th>
<th>Deferred Inflow</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lessee</strong></td>
<td>Amortize the intangible asset over shorter of useful life of the asset or lease term</td>
<td>Reduce by lease payments (less interest expense recognized)</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Lessor</strong></td>
<td>Depreciate leased asset</td>
<td>N/A</td>
<td>Recognize revenue over the lease term in a systematic and rational manner</td>
</tr>
<tr>
<td></td>
<td>Reduce receivable by lease payments (less payments for interest)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Key Concepts and Terms
What is the Lease term?

Lease term = Noncancellable lease period + Optional renewal periods if lessee is reasonably certain to exercise + Periods after an optional termination date if lessee is reasonably certain not to exercise that option + Optional periods to extend (or not to terminate) the lease in which exercise of option is controlled by the lessor

The lease term is determined at the commencement date (i.e. the date the underlying asset is available to the lessee)!

What does reasonably certain mean?
Reasonably certain

— Reasonably certain is a high threshold of probability that must be met to include optional lessee payments in the measurement of lease assets and lease liabilities.

— Lessee has a compelling economic reason to exercise the renewal or purchase option (or not to exercise a termination option).

— Consider all economic factors relevant to the assessment.
What is included in Lease payments?

<table>
<thead>
<tr>
<th>Lease payments include:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed payments</strong></td>
</tr>
<tr>
<td>Include unless reasonably certain not to be exercised (lessee only)</td>
</tr>
<tr>
<td><strong>Termination penalties</strong></td>
</tr>
<tr>
<td>Include unless reasonably certain not to be exercised (lessee only)</td>
</tr>
<tr>
<td><strong>Purchase options</strong></td>
</tr>
<tr>
<td>Include only if reasonably certain to exercise (lessee only)</td>
</tr>
<tr>
<td><strong>Variable lease payments (VLPs)</strong></td>
</tr>
<tr>
<td>Only VLPs that depend on an index or rate are included</td>
</tr>
<tr>
<td><strong>Residual value guarantees (RVGs)</strong></td>
</tr>
<tr>
<td>Amounts reasonably certain of being paid (Lessees only, different guidance for lessor)</td>
</tr>
<tr>
<td><strong>Any other payments</strong></td>
</tr>
<tr>
<td>Include only if reasonably certain (lessee only)</td>
</tr>
</tbody>
</table>
# Lease payments - details

## Fixed payments (lessee and lessor)

- **Fixed payments** – Contractually fixed and not subject to any variability.
- **In-substance fixed payments** – May be described as variable but are “in-substance fixed” because contract terms ensure payment of a fixed amount is unavoidable.
- **Lease incentives** – Defined as (a) 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 (b) other concessions granted to the lessee. Lease incentives that are fixed and are to be provided after the commencement date are deducted from the fixed lease payments in the measurement of the lease liability.

## Termination penalties (lessee only)

- If the lease term reflects a lessee exercising (1) and option to terminate the lease or (2) a fiscal funding or cancellation clause, then any penalty associated with that termination option should be included in the lease payments.
Lease payments - details

**Purchase options (lessee only)**
- If the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease payment.

**Variable lease payments (VLPs) (lessee and lessor)**
- Only VLPs that depend on an index or rate are included
  - e.g. increases/decreased based on Consumer Price Index (CPI)
- Use index or rate at commencement date. Forward rates and forecasting techniques are not considered.
  - Therefore, when initially measuring the lease payments, the current index or rate is assumed to stay in effect.
- VLPs based on future performance or usage are not included, even if they are highly certain!

If variable lease payments are not included in the lease liability how are they accounted for when paid?
Lease payments - details

| Residual value guarantees (RVGs) | • A RVG is a guarantee by a lessee to a lessor that the value of the underlying asset returned to the lessor at the end of the lease will be at least a specified amount.  
| | • **Lessee** – Include amounts reasonably certain of being paid  
| | • **Lessor** – Include only those that are fixed in substance |

| Any other payments (lessee only) | • Include only if reasonably certain |

Assume a lessee has entered into a lease for an automobile that requires the following additional payments (assessed at the end of the lease):
• $1 per mile for each mile over 30,000 miles
• Specific charges related to the condition of the vehicle (paint, interior, etc.) as outlined in the lease contract

**Should these payments be included in the “lease payments” for calculation of the lease liability by the lessee and lease receivable by the lessor?**
Discount rate

Lease payments

Interest rate the lessor charges the lease: This may be the rate implicit in the lease. The rate implicit in the lease is the rate of interest that, at a given date, causes the present value of the net investment in the lease to equal the sum of the fair value of the underlying asset and any capitalized initial direct costs of the lessor.

Incremental borrowing rate: An estimate of the rate of interest that would be charged for borrowing the lease payment amounts during the lease term.

Present value of future lease payments
Multiple lease components

Step 1: Identify separate lease components
- Leases may contain multiple lease components (e.g. multiple pieces of equipment)
- If lease components have different lease terms, they must be accounted for separately
- If underlying assets are in different major classes of assets for disclosure purposes, they must be accounted for separately

Step 2: Identify any non-lease components
- Non-lease components must be separated from lease components and accounted for separately
- Non-lease components should be accounted for under applicable non-lease guidance. Many times these components are service contracts.

Step 3: Allocate the contract price
- Use prices for individual components that are included in the contract, as long as not unreasonable
- If contract doesn’t include separate prices for individual components or they seem unreasonable, use judgment to determine the best estimate for allocation to each component, but always maximizing the use of observable information
Where to Start?
What does it really mean?

— Read and know the standard!
  ▪ Attend additional trainings – details are complex!

— There are considerable impacts on entities adopting this standard that need to be addressed early and up-front. Some considerations are:
  ▪ Systems and processes / identifying a complete population of leases
  ▪ Controls
  ▪ Business and people
  ▪ Contracts
  ▪ Debt covenants
  ▪ Financial statement ratios
Implementation Steps

1. Make a plan and set milestones
2. Identify the lease population
3. Create template and gather information
4. Prepare journal entries to record leases
5. Modify processes, systems, and controls
6. Tips and tools
Make a plan and set milestones

Create a project team that will lead the implementation.

Set milestones and stick to them.

Involve other necessary functions, such as legal, procurement or operational departments.
Identify the lease population

- Rent expense
- Capital leases
- Construction agreements
- Other Contracts

Non-reported activities:
- Search for unrecorded leases!
- Consult with legal and procurement
- Consult with operational departments if decentralized
Create template and gather information

— Document key provisions and decisions, such as:

<table>
<thead>
<tr>
<th>Description of contract, commencement date</th>
<th>Lease term, option periods, termination clauses</th>
<th>Lease modification dates and descriptions</th>
<th>Lease payments, purchase options, termination penalties, RVG’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rationale for “reasonably certain” decisions</td>
<td>Measurement assumptions (discount rate)</td>
<td>Consultations to clarify ambiguous lease provisions</td>
<td></td>
</tr>
</tbody>
</table>

Reference key terms and decisions to supporting agreements as applicable!
Prepare journal entries

— Consider lease modifications and re-measurements in relation to retroactive implementation to earliest year presented

— Reference/include supporting documentation gathered in the template and agreements for all entries

— Keep detailed and consistent documentation – will be needed for the audit!
Modify processes, systems and controls

— Centralize process to control contract population
  ▪ Establish review of all contracts to determine proper reporting
  ▪ Establish process to identify triggering events
    • Lease modifications
    • Lease re-measurements
    • Impairment
— Revisit/revise policies and procedures
— Provide training
Tips and tools

1. **Start early**
   Especially for larger and more complex governments and governments with limited accounting resources

2. **Educate stakeholders**
   E.g. Boards, elected officials,

3. **Create templates**
   Or checklists

4. **GASB 87**
   Consult the Implementation Guide (expected ____)

5. **Consult**
   Auditors or GASB

6. **Additional help**
   Consider hiring outside help
Key points to remember!

— One of the key first steps in applying GASB 87 is to determine the population of leases using the updated definition of a lease.

— Properly determining lease term, lease payments and the discount rate is critical as these will have a significant impact on what is recorded in the financial statements.

— GASB 87 requires retrospective application which involves considerable upfront efforts.
Thank you