Hot Topics

Implementing GASB 87 – Accounting for Leases

Speakers:

Julie Barrientos, KPMG LLP
Brian Tinney, State of Washington

National Association of State Comptrollers
March 17, 2020
Agenda

— Finding Embedded Leases
— Separating Multiple Component Leases
— Determining Discount Rate
— Required Disclosures
Embedded Leases
Embedded leases

What is the challenge with embedded leases?

— There may be leases embedded in existing contracts that were previously not identified
— Many contracts will not use the terms “lease” or “rent” that allow for easier identification
— Critical evaluation may be required to determine whether a right to control the use of an asset is created by the contract

Where are embedded leases often found?

— Advertising agreements
— Service agreements
— Transportation agreements
— Construction agreements
— Related party charges
Example – Shuttle service

— University A has multiple campuses. Students frequently have to travel between campuses and parking lots that are far apart from each other.
— University A engages Shuttle Service to provide shuttle bus service around its campuses to its students, employees, and visitors.
— Ten buses used by Shuttle Service are dedicated to University A’s contract. University A can only use the buses on its campuses.
— University A dictates the routes, frequency, and hours of operation for the shuttle service.
— Shuttle Service operates and maintains the buses.

Contract for shuttle service

Relevant decision-making rights that are partially predetermined:

- What
- Where

Relevant decision-making rights available to be made during the period:

- When
- Whether
- How Much
- What*
- Where*

Substantive decisions about how and for what purpose the asset is used are not predetermined.

Customer has the right to direct ‘how and for what purpose’ the asset is used.

Contract contains a lease

* These are partially determined
Multiple Component Leases
## Separating components

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

<table>
<thead>
<tr>
<th>Step 2: Identify any non-lease components</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Non-lease components must be separated from lease components and accounted for separately</td>
</tr>
<tr>
<td>- Non-lease components should be accounted for under applicable non-lease guidance. Many times these components are service contracts.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 3: Allocate the contract price</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Use prices for individual components that are included in the contract, as long as not unreasonable</td>
</tr>
<tr>
<td>- 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</td>
</tr>
</tbody>
</table>
## Separating components

**Components of a contract = items or activities that transfer a good or service to the lessee**

<table>
<thead>
<tr>
<th>Example nonlease components</th>
<th>Not a separate component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Providing utilities (e.g. water or electricity) to the lessee</td>
<td>Delivering the leased asset</td>
</tr>
<tr>
<td>Common area maintenance</td>
<td>Reimbursement of lessor costs for property taxes or insurance</td>
</tr>
<tr>
<td>Equipment maintenance or operation</td>
<td>Residual value guarantee</td>
</tr>
</tbody>
</table>
Separating Components – Practice Issue

Are governments properly identifying and allocating contract prices to separate components in multiple component contracts?

- Remember that GASB has clearly stated that inconvenient should not be considered equivalent to not practicable.

- Prices must be allocated to each separate component using best estimates if there are no stated prices, or if the stated prices appear to be unreasonable.

- If determining a best estimate to allocate contract prices to the different components is not practicable, multiple components in a lease contract should be accounted for as a single lease unit.

- Departures from these requirements would be considered a non-gaap policy.
Discount rate
# Discount rate

## Lease payments

<table>
<thead>
<tr>
<th>Lessor</th>
<th>Lessee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest rate the lessor charges the lessee:</strong> 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.</td>
<td><strong>Interest rate the lessor charges the lessee:</strong> 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.</td>
</tr>
</tbody>
</table>

**Discount rate**

**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
Lessor discount rate

GASB issued a Q & A on lessor discount rate in its exposure draft in November 2019 (final expected April, 2020)

- 4.17. Q—Paragraph 47 of Statement 87 requires a lessor to discount the future lease payments to be received using the interest rate the lessor charges the lessee. How should the lessor determine that rate?
- A—If the lease contract contains a stated interest rate, the lessor should use that rate. In the absence of a stated rate, the lessor should determine whether the rate implicit in the lease can be estimated. Paragraph 47 of Statement 87 provides that lessors may apply the guidance for imputation of interest in paragraphs 173–187 of Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements. Paragraph 183 of Statement 62 states that “the prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate. . . .” Lessors may use professional judgment to determine their best estimate for the interest rate, maximizing the use of observable information; for example, using the lessee’s estimated incremental borrowing rate or published market rates for similar instruments. If it is not practicable for the lessor to estimate the discount rate through those methods, the lessor’s own incremental borrowing rate may be used.
Lessee discount rate

Rate the lessor charges the lessee

— Required when readily determinable
— Expected that use will be infrequent because:
  ▪ Most leases do not explicitly state the lessor’s rate.
  ▪ Even if explicitly stated, may be difficult to evaluate whether stated rate is reasonable and reflective of what the lessor actually used.
  ▪ Lessee usually will not know the lessor’s estimate of residual value.
  ▪ It will be difficult to estimate a residual value with any level of precision.
  ▪ Will require significant effort on part of lessee to perform a separate analysis for each lease.
  ▪ Could result in a wide disparity of implicit rates for different leases with similar terms.
Lessee discount rate

Incremental borrowing rate (IBR)

— It is a entity-specific rate that reflects the creditworthiness of the government.
— Rate should reflect:
  - The terms of the arrangement
  - The amount of the funds “borrowed”
  - The economic environment, encompassing the jurisdiction and the currency in which the lease was entered into.
— Maximize use of observable inputs
  - Recent issuances of serial bonds
  - Other debt issued by government
— Consider and adjust for the terms of the lease
— Rate generally should not consider the underlying asset leased
Incremental Borrowing Rate Practice Issue

Specific guidance on how to calculate the IBR not provided

— Should the type of debt that would have been issued to purchase the asset be considered?
— Should IBR be a taxable or tax exempt rate
— What type of debt should be considered?
  — General obligation bonds
  — Revenue bonds (including certificates of participation)
  — Installment loans
  — Other
— How frequently should IBR be recalculated?
— Should a government develop its own yield curve to address differences in lease terms?
Potential Approach

— Establish a policy that considers type of debt that would be issued to purchase the asset when determining the IBR
— Establish a policy to reevaluate IBR quarterly
— Use published yield curves as basis, consistent with a government’s uninsured bond rating
— Adjust published yield curves based on observable market activity of government’s own bonds
Disclosures
Key considerations for lease disclosures

— Summary of significant accounting policies
  ▪ Basis of accounting (lessee – modified accrual)
  ▪ Capital assets (lessee)
  ▪ Lease accounting policies
  ▪ Deferred outflows of resources/deferred inflows of resources (if applicable)

— Where to include transaction specific disclosures
  ▪ Separate lease note, or
  ▪ Detailed notes on capital assets, long-term debt, and commitments

— Terminology for lease/subscription IT assets and liabilities
— How SBITA will impact disclosures
What questions do you have?
Thank you
Example: Components of a contract

- The State entered into a 5-year lease for office space for $30,000/year.
- The office space is on the ground floor of one of the lessor’s mixed-use properties.
- The annual lease payment covers the lessor’s performance of common area maintenance, such as cleaning the common areas, parking lot maintenance, and general repairs of common areas.
Example: Components of a contract

**Analysis**
There are two components to this contract:
- A non-lease component for the common area maintenance
  - A lease component for the remainder
- The payment must be allocated between the two components
- The non-lease component represents a service contract and should be accounted for as such
- The lease component is accounted for as a lease
Gross lease – observable prices

**Contract Price**
- Rent (fixed payment) $100,000

**Components**
- Building (lease component)
- CAM (nonlease component)

**Additional facts:**
- Using published real estate studies, Lessee determines that following prices are reasonable for similar properties:
  - Annual lease payments of $115,000
  - Common area maintenance payments of $10,000 per year
Components and allocation

Separating components of the contract (Lessee)

- **Step 1**: There is a single lease component (lease of real estate)
- **Step 2**: There is one nonlease component (common area maintenance)
- **Step 3**: Contract price of $500,000 is allocated between the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-alone price</th>
<th>Allocation</th>
<th>Alloc. %</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease</td>
<td>$575,000</td>
<td>$460,000</td>
<td>92%</td>
<td>((575,000 / 625,000) \times 500,000)</td>
</tr>
<tr>
<td>Nonlease</td>
<td>50,000</td>
<td>40,000</td>
<td>8%</td>
<td>((50,000 / 625,000) \times 500,000)</td>
</tr>
<tr>
<td></td>
<td><strong>$625,000</strong></td>
<td><strong>$500,000</strong></td>
<td><strong>100%</strong></td>
<td></td>
</tr>
</tbody>
</table>
Components and allocation

Separating components of the contract (Lessee)

- **Step 3 (con't):** Allocate annual payments to each component

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Amount</th>
<th>Lease Component (92%)</th>
<th>Nonlease Component (8%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>At signing</td>
<td>$100,000</td>
<td>$92,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Beg. of Year 2</td>
<td>100,000</td>
<td>92,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Beg. of Year 3</td>
<td>100,000</td>
<td>92,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Beg. of Year 4</td>
<td>100,000</td>
<td>92,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Beg. of Year 5</td>
<td>100,000</td>
<td>92,000</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td>$500,000</td>
<td>$460,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>