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What Financial Statement Preparers Need to Know About GASB's New Lease Accounting Proposal

PROMOTING EXCELLENCE IN GOVERNMENT

Today's Presenter

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Overview

- Brief Description:
  - This session will provide an overview of GASB's Reexamination of Lease Accounting Guidance (NCGA Statement 5 and GASB Statement 13).
- Objectives:

  At the end of this session, the participant should be able to:
    - Compare and contrast the current guidance with the proposed guidance
    - Recall lessee and lessor accounting requirements
    - Recall required note disclosures

Introduction

- **What:** In January 2016, an Exposure Draft was issued proposing revisions to existing standards on lease accounting and financial reporting.
- **Why:** Existing standards have been in effect for decades without review to determine if they remain appropriate and useful. FASB and IASB updated their lease standards providing the opportunity to increase comparability and usefulness of information as well as reducing complexity for preparers.
- **When:** Final changes are expected in May 2017.

Project Overview – Reexamination of NCGA No. 5 and GASB No. 13

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Current Guidance

- **National Council on Governmental Accounting (NCGA) Statement 5**, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*
- **GASB Statement No. 13**, *Accounting for Operating Leases with Scheduled Rent Increases*
- **GASB Statement No. 62**, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB & AICPA Pronouncements*
  - Incorporates provisions of FASB Statement No. 13, Accounting for Leases
- **GASB Statement No. 65**, *Items Previously Reported as Assets and Liabilities*

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Project Timeline

Pre-Agenda Research Started	April 2011
Added to Current Technical Agenda	April 2013
Preliminary Views Approved	November 2014
Exposure Draft Issued	January 2016
Comment Period Ended	May 2016
Final Statement Expected	May 2017
Proposed Effective Date	Periods beginning after December 15, 2018

GASB is currently deliberating the responses to the exposure draft and is scheduled to meet again in January 2017.

Background

- Under current guidance most leases are reported as operating leases. Even though operating leases represent long-term commitments, no liabilities are reported, and there is disclosure only. Likewise, no assets are reported even though the government receives the legal right to use an underlying asset.

- Currently, leases have to meet one of four criteria to be recorded as a capital lease: 1) Ownership, 2) Bargain purchase option, 3) Lease term, 4) Present value

- In Concepts Statement No. 4, *Elements of Financial Statements*, the definitions of liabilities and assets are established. This project provides the opportunity to consider whether operating leases meet the definitions of assets and liabilities.

- 2010 and 2013, FASB and IASB issued Exposure Drafts proposing to replace private sector guidance for leases. Final guidance was issued in February and January 2016, respectively.

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Background

- GASB simultaneously entered into a lease accounting project to follow the progress of FASB/IASB project.
- The project provides an opportunity to reassess the existing GASB guidance, while considering improvements in the FASB/IASB project with the context of the unique nature of governmental entities.
- Part of GASB's strategic plan is to evaluate the effectiveness and impact of the long-term existing standards NCGA No. 5 issued in 1982 and GASB No. 13 issued in 1990.

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Accounting and Financial Reporting Issues

The main topic of consideration is the form of financial reporting display and disclosure necessary to meet essential financial statement user needs. The following issues are being considered:

1. Are current accounting and financial reporting standards, including the distinction between types of leases, appropriate to meet essential user needs?
2. If current standards are not considered adequate, what other requirements should be considered?

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Leases

Question #1

Currently, how are leases classified by governments?

A. Current and long term
B. Capital and Operating
C. Financing and Capital
D. Legal and Nonconforming

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Scope and Approach of Reporting

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Definition of a Lease

- A lease would be defined as a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction.
  - Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition would be accounted for under the proposed lease guidance, unless specifically excluded.
- Leases are financings of the right to use an underlying asset. Therefore, a single approach will be applied to accounting for leases with some exceptions, such as short-term leases.

Lease Term

- The lease term would be defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable, covered by a lessee's option to:

  a. Extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option

  b. Terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option.

- Periods for which both the lessee and the lessor have an option to terminate the lease, or for which only the lessor has that option, are <u>cancelable periods and are excluded from the lease term</u>. Provisions that allow for termination of a lease due to (a) purchase of the underlying asset, (b) payment of all sums due, or (c) default on payments, are not considered termination options.

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Lease Term

- A fiscal funding or cancellation clause would be considered in determining the lease term only when it is reasonably certain that the clause will be exercised.

- Lessees and lessors would reassess the lease term only if the lessee does either of the following:

  a. Elects to exercise an option even though the lessor or lessee had previously determined that it was reasonably certain that the lessee would not exercise that option

  b. Elects to not exercise an option even though the lessor or lessee had previously determined that it was reasonably certain that the lessee would exercise that option.

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Lease Term

- At the beginning of a lease, the lessor and the lessee should assess all factors relevant to the likelihood that the lessee will exercise options, whether these factors are contract based, underlying asset based, market based, or government specific. These might include:

  - Significant economic incentives for any optional periods

  - Significant economic disincentives to terminate and sign a new lease

  - Lessee's history of exercising renewal or termination options

  - Extent to which lease is essential to the government

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Initial Reporting – Economic Resources Measurement

	Assets	Liabilities	Deferred Inflow
Lessee	Intangible asset (right to use underlying asset) – value of lease liability plus prepayments and initial direct costs that are ancillary to place asset in use. A lease that transfers ownership of the asset to the lessee during or at the end of the lease and does not contain termination options should be reported as a financed purchase. This does not include purchase options.	Present value of future lease payments (incl. fixed payments, variable payments based on index or rate, reasonable certain residual guarantees, etc.) Discount rate should be the lessor's rate of charge or if not present the lessee's incremental borrowing rate	N/A
Lessor	Lease receivable (generally including same items as lessee liability) Continue to report leased asset.	N/A	Equal to lease receivable plus any cash received up front that relates to a future period.

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Subsequent Reporting - Economic Resources Measurement

	Assets	Liabilities	Deferred Inflow
Lessee	Amortize the intangible asset over shorter of useful life or lease term.	Reduce by lease payments (less amount for interest expense).	N/A
Lessor	Depreciate leased asset (unless indefinite life or required to be returned in its original or enhanced condition). Reduce receivable by lease payments (less payment needed to cover accrued interest).	N/A	Recognize revenue over the lease term in a systematic and rational manner.

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Reporting – Current Financial Resources Measurement

- **Lessee** would report for funds using the current financial resources measurement focus at the fund level on a basis consistent with governmental fund accounting principles by reporting the amount of the asset as an expenditure and other financing source.

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Leases

Question #2

GASB's proposed statement on leases establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under the economic resource measurement focus, how would a government (lessee) record a lease?

	Debit	Credit
A.	Expenditure	Other Financing Sources
B.	Capital Assets	Accounts Payable
C.	Intangible right-to-use asset	Lease Liability
D.	Capital Assets	Other Financing Sources

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Note Disclosures

- **Lessee** would include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.
- **Lessor** would include a description of leasing arrangements and the total amount of revenue recognized from leases.

Note Disclosures for Lessee

Lessees must disclose the following:

- A general description of its leasing arrangements, including:
  (1) The basis, terms, and conditions on which variable lease payments not included in the lease liability are determined and
  (2) The existence, terms, and conditions of residual value guarantees provided by the lessee
- The total amount of lease assets, and the related accumulated amortization, to be disclosed separately from other capital assets
- The amount of lease assets by major classes of underlying assets, to be disclosed separately from other capital assets
- The amount of outflows of resources recognized for the period for variable lease payments not previously included in the lease liability

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Note Disclosures for Lessee

Lessees must disclose the following:

- The amount of outflows of resources recognized for the period for other payments, such as residual value guarantees or penalties, not previously included in 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 that have not yet begun
- The components of any net impairment loss (gross impairment loss less change in lease liability) recognized on the lease asset during the period

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Note Disclosures for Lessor

Lessors must disclose the following:

- A general description of its leasing arrangements, including the basis, terms, and conditions on which any variable lease payments not included in the lease receivable are determined
- The carrying amount of assets on lease or held for leasing, by major classes of assets, and the amount of accumulated depreciation
- 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 the total is not displayed on the face of the financial statements

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Note Disclosures for Lessor

Lessors must disclose the following:

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

- Amendments to a lease would be considered a modification unless it decreases the lessee's right to use the assets.
- A modification would involve remeasuring the lease asset and liability by the lessee or receivable and deferred inflow of resources by the lessor.
- A termination would involve reducing the lease asset and liability by the lessee or the lease receivable and deferred inflow of resources by the lessor, with any difference being recognized as a gain or loss.
- Subleases where the lessee is now a lessor on the sublease would be accounted for separately from the original lease.

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Short-Term Leases

- Maximum term under contract is 12 months (from beginning of lease)
- Lessees recognize expense/expenditures based on terms of the contract
  - Do not recognize assets or liabilities associated with the right to use the underlying asset for short-term leases
- Lessors recognize lease payments as revenue based on the payment provisions of the contract.
  - Do not recognize receivables or deferred inflows associated with the lease

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Practical Example: Copier Lease

- **Background Information:** The City routinely enters into lease agreements for copiers and other small office equipment. On July 1, 2019, the City entered into a lease for a new copier with the following criteria:
  - Lease requires monthly payments of $1,128.11 for 36 months
  - At the end of the lease term, the City has the option to purchase the copier at fair value or return the copier to the lessor
  - The fair value of the copier at commencement is $48,000
  - The useful life of the copier is 7 years
  - The interest rate on the lease is 8.0%
  - Present value of the minimum lease payments required under the lease is $36,000 (See amortization schedule on next slide)

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Practical Example: Copier Lease

City Copier Lease Example

Compound Period .... : Monthly

Nominal Annual Rate .... : 8.000 %

CASH FLOW DATA

	Event	Date	Amount	Number	Period	End Date
1	Loan	07/01/2019	36,000.00	1		
2	Payment	08/01/2019	1,128.11	36	Monthly	07/01/2022

AMORTIZATION SCHEDULE - Normal Amortization

	Date	Payment	Interest	Principal	Balance
Loan	07/01/2019				36,000.00
1	08/01/2019	1,128.11	240.00	888.11	35,111.89
2	09/01/2019	1,128.11	234.08	894.03	34,217.86
3	10/01/2019	1,128.11	228.12	899.99	33,317.87

Practical Example: Copier Lease

- **What decisions would we be necessary under existing lease guidance prior to the proposed guidance we are discussing today?**
  - Capital or Operating?
    - Ownership – Does ownership of the copier shift from lessor to City?
    - Bargain purchase option – Does the City have an option to purchase the copier for an amount less than fair value?
    - Lease term – Does the period of the lease encompass at least 75% of the useful life of the asset?
    - Present value – Does the present value of the minimum lease payments required under the lease exceed 90% of the fair value of the copier?

Practical Example: Copier Lease

- **Under existing lease guidance, prior to proposed guidance we are discussing today, we would account for this copier lease as an operating lease as follows:**
  - **General Fund (Fund Level; Current Financial Resources Measurement Focus)**
    - **No asset or liability to record**
    - **As monthly lease payments are made:**
      - **Debit rent expenditure for $1,128.11**
      - **Credit cash for $1,128.11**
  - **Governmental Activities (Government-Wide Level; Economic Resources Measurement Focus)**
    - **No asset or liability to record; No reconciling items from fund-level to government-wide level**
    - **Rent expenditure would be reported by function**

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Practical Example: Copier Lease

- **What decisions would we be necessary under the proposed guidance we are discussing today?**
  - Does this contract meet the definition of a lease?
    - Conveys the right to use a nonfinancial asset?
    - Exchange or exchange-like transaction?
  - What is the lease term?
    - 12 months or less?
    - Any options to extend or terminate the lease?
    - Likelihood of exercising any options?

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Practical Example: Copier Lease

- Under the proposed guidance we are discussing today, the copier lease would be accounted for as follows:
  - General Fund (Fund Level; Current Financial Resources Measurement Focus)
    - No asset or liability to record
    - Upon entering into contract:
      - Debit capital outlay expenditure for $36,000
      - Credit other financing source for $36,000
    - As monthly lease payments are made:
      - Debit principal pmts. expenditure for $888.11 (1st Pmt.)
      - Debit interest pmts. expenditure for $240.00 (1st Pmt.)
      - Credit cash for $1,128.11

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Practical Example: Copier Lease

- Governmental Activities (Government-Wide Level; Economic Resources Measurement Focus)
  - Asset and liability to record; Reconciling items from fund-level to government-wide level are necessary
  - Upon entering into contract:
    - Debit intangible right-to-use asset for $36,000
    - Credit capital outlay expenditure for $36,000
    - Debit other financing source for $36,000
    - Credit lease liability for $36,000
  - As monthly lease payments are made:
    - Debit lease liability for $888.11 (1st Pmt.)
    - Credit principal pmts. expenditure for $888.11 (1st Pmt.)
  - On a monthly basis:
    - Debit amortization expense for $1,000
    - Credit accumulated amortization for $1,000

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Leases

Question #3

A short-term lease would be defined as a lease that, at the beginning of the lease, has a maximum possible term under the contract of 12 months or less, including any options to extend, regardless of its probability of being exercised. How would a lessee record short-term lease payments in a governmental fund?

A. The same as any other recurring payment
B. An outflow of a resource based on payment provisions of the contract
C. The same as you would for a proprietary fund
D. All of the above are correct

Summary

- Final Statement expected in May 2017
- All leases will be presented in a "one-stream approach" (Balance Sheet), with the exception of short-term leases (12 months or less), which will be allowed the current operating lease type structure
- All other leases will meet the requirements of intangible assets and lease receivables
- Proposed implementation date for reporting periods beginning after December 15, 2018

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Questions?

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