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Lease Accounting (GASB Filers)

Authors:
Carrie Rice, CPA, Magali Welch, CPA, CA, AIAF

Johnson Lambert is dedicated to keeping you up to date on the impact the Governmental Accounting Standards Board (GASB) Statement No. 87, *Leases* will have on your financial statements. This white paper presents the most significant changes to lease accounting and reporting. GASB 87 is effective for reporting periods beginning after December 15, 2019.

Background

In 2017, GASB 87 was issued to improve the accounting and reporting for leases. The new guidance establishes a single approach to accounting for leases and provides more transparency on future obligations. Lessee's will record a right-to-use lease asset and a lease liability for future obligations on the Statement of Net Position. Lessor's will record a lease receivable and a deferred inflow of resources.

Definition, Classification and Measurement

GASB 87 defines a lease 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." Examples of nonfinancial assets include buildings, vehicles and equipment.

Accounting Treatments

Short-term leases are those with a maximum lease term of twelve months or less, including extension options (irrespective of the probability of being exercised). Accounting for short-term leases is functionally the same as the current accounting for operating leases.

Lease contracts that transfer ownership of an asset at the end of the lease term and do not contain termination options are treated as a sale and recorded as a financed purchase.

All other leases that do not fall into the short-term lease or lease contracts that transfer ownership categories are accounted for using the new single-model approach.

Single-Model Approach

The core principle of the single-model approach is that an entity must recognize assets and liabilities on the Statement of Net Position as described below:

	Line Item	Initial Measurement	Subsequent Measurement
Lessee	**Right-to-Use Asset**	Total of the lease liability plus lease prepayments, less impairment and initial costs to place the leased asset in service	Amortized over the shorter of the lease term or useful life of the right-to-use asset
	Lease Liability	**Present value** of lease payments over the lease term, less any lease incentives	Reduced for principal payments made
Lessor	**Lease Receivable**	**Present value** of lease payments over the lease term, less provisions for uncollectible amounts	Reduced for principal payments received
	Deferred Inflow of Resources	Total of the lease receivable plus lease prepayments	Amortized over the shorter of the lease term or the useful life of the right-to-use asset

Lease Term

The lease term is an important measurement of a lease and is comprised of:

- The noncancelable period,
- Periods for which it is *reasonably certain* that renewal options will be exercised,
- Periods for which it is *reasonably certain* that termination options will <u>not</u> be exercised

It is necessary to consider any renewal periods reasonably certain to be exercised, and periods covered by termination options if the lessee is reasonably certain of not exercising them and any periods from an option to extend (or not terminate) controlled by the lessor. While there is no bright-line test for "reasonably certain", it is equitable to "reasonably assured" in the current guidance. When evaluating if terms are reasonably certain, accumulated factors of economic incentives at the lease commencement date that would prompt a lessee to renew, or not renew, need to be considered (for example, the lease renewal is below market rates, lease termination or relocation costs would be avoided, the importance of the asset to the lessee's operations, etc.).

Leases with related parties and affiliated organizations that have an understanding that the agreement will stay in effect for many years, should not be considered short-term leases.

Lease Modifications

During the lease term, changes may occur and may include:

	Lessee	Lessor
Lease term	X	X
Purchase option no longer certain to be realized (or vice versa)	X	
Guaranteed residual value	X	
Interest rate charged by lessor	X	X
Variable payments	X	X

Accordingly, the lease asset and liability will be adjusted using revised inputs at the reassessment date. However, a lease modification that adds one or more underlying assets and includes a reasonable increase in lease payments should be accounted for as a separate lease.

Lease Terminations

Any amendment that shortens the lease term or reduces the number of underlying assets is considered a partial or full termination of the lease by reducing the assets and liabilities and recording a gain or loss, if any.

Discount Rate

The lessee must review the contract to determine which discount rate to apply. If a discount rate is not explicitly stated or the lessee is unable to calculate the implicit rate of the lease contract, the lessee shall default to the incremental borrowing rate, which is an estimate of the rate that would be charged by a bank or lender for the same amount and lease term.

Discount rates should be reassessed in the following instances:

	When?	What is the effect?
Lessee	Upon a change in the lease term or when a purchase option is no longer certain to be realized (or vice versa).	Lease assets and liabilities are adjusted using the new interest rate in the period of change and on a prospective basis.
Lessor	Upon a change in the lease term or interest rate	Lease receivables and deferred inflow of resources are adjusted using the new interest rate in the period of change and on a prospective basis.

Contracts with Multiple Components

Lessees and lessors may enter into contracts that contain lease and nonlease components, such as common area maintenance services. When a lease contains multiple underlying assets with different lease terms or in different major asset classes, each underlying asset is accounted for as a separate lease contract.

The contract price should be allocated to the different components based on prices for the individual components, as long as the price allocation is not unreasonable per the terms of the contract and professional judgement. When the contract does not include individual prices or the prices are unreasonable, the price should be allocated using a best estimate, maximizing the use of observable information. If this is not practicable, the contract is accounted for as a single lease based on the terms of the primary lease component.

Sublease

An original lessee that becomes a lessor in a subleasing agreement should account for the original lease and sublease as separate transactions as the lessee and lessor, respectively.

Incentives

Incentives received by the lessee prior to the contract effective date shall be recorded by first reducing any prepayments made to the lessor, then as an advancement incentive (liability) until the lease effective date, then a reduction of the lease asset. The lessor should recognize an asset. Upon commencement of the lease, the asset should reduce the deferred inflow of resources.

Indirect Costs

When a lease is executed, there are costs that would not have been incurred otherwise. Those costs, while not considered when measuring the liability carried, are considered when measuring the value of the right-to-use asset. Only those costs directly related to the execution of the lease are considered; costs related to the negotiation of the lease are excluded and expensed as incurred.

Examples of included costs are:	• Commissions • Legal fees incurred as part of the execution of the lease • Certain payments to existing tenants to relocate
Examples of excluded costs are:	• Employee salaries • Legal fees incurred as part of negotiation of the lease term and conditions • Advertising

ILLUSTRATIONS

Example 1 – Lessee accounting for a short-term lease

Company A enters into a lease with the following terms:

- Effective date: January 1, 2020
- Length: 12 months
- Asset type: Equipment with 10-year useful life
- Payments: $1,000/month
- Transfer of ownership: No
- Purchased options: None

The lease will be treated as a short-term lease and Company A will record the following monthly entry:

On January 1, 2020:

DR Equipment rent expense:	$1,000	
CR Cash		$1,000

Example 2 - Lessee accounting for a lease (non-short-term and non-ownership)

Company B enters into a non-cancelable lease with the following terms:

- Effective date: January 1, 2020
- Length: 5 years
- Asset type: Building with 60-year useful life
- Interest rate: 4%
- Payments: $3,000/month
- Transfer of ownership: No
- Purchase options: None

Because the lease term is greater than twelve months and ownership is not transferred, the lessee recognizes a right-to-use asset and a lease liability as such:

Present value of lease payments (rounded) = $159,615
Total lease payments = $180,000

Straight-line amortization over the shorter of the lease term or the useful life

		Components of the lease payment:		Balances for lessee to recognize:	
Date	Lease Payment	Interest rate 4%	Loan Amortization	Asset	Liability
01/01/2020				$159,615	$159,615
12/31/2020	$36,000	$7,181	$28,819	$127,692	$130,796
12/31/2021	$36,000	$5,706	$30,294	$95,769	$100,502
12/31/2022	$36,000	$4,157	$31,843	$63,846	$68,659
12/31/2023	$36,000	$2,527	$33,473	$31,923	$35,185
12/31/2024	$36,000	$815	$35,185	-	-
Totals	$180,000	$20,385	$159,615		

The liability is reduced by the difference between the interest expense and lease payment

Company B will record the following entries:

On January 1, 2020:

DR Right-to-Use Asset (office space)	$159,615	
CR Lease Liability		$159,615

To record the original lease

On December 31, 2020:

DR Lease Liability	$28,819	
DR Interest expense	$7,181	
CR Cash		$36,000

To record first year payments

DR Amortization	$28,819	
CR Right-to-Use Asset - Accumulated Depreciation		$28,819

To record first year amortization

Disclosures

Lessees and lessors are required to provide a general description of their lease arrangements as well as the following disclosures:

Lessee	Lessor
Total amount of lease assets and the related accumulated amortization	Total amount of inflows of resources recognized in the reporting period from leases, if that amount cannot be determined based on the amounts displayed on the face of the financial statements
Lease assets by major classes of underlying assets	The amount of inflows of resources recognized in the reporting period for variable payments and other payments not previously included in the measurement of the lease receivable, including inflows of resources related to residual value guarantees and termination penalties
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 existence, terms, and conditions of options by the lessee to terminate the lease or abate payments if the lessor has issued debt for which the principal and interest payments are secured by the lease payments
The amount of outflows of resources recognized in the reporting period for other payments, such as residual value guarantees or termination penalties not previously included in the measurement of 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 before the commencement of the lease term	
The components of any loss associated with an impairment	

Application

The requirements should be applied retroactively by restating financial statements for all prior periods presented, if practicable. Leases should be recognized and measured using the facts and circumstances that existed at the lease commencement date or the beginning of the earliest period restated, whichever occurred later.