**Government Industry Alert**
**By CalCPA Governmental Accounting & Auditing Committee and**
**California Committee on Municipal Accounting**
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# GASB 87, *Leases*

## Disclaimer

This Government Industry Alert is not authoritative guidance. The views expressed in this Government Industry Alert are not official positions of the GASB, the AICPA, the CalCPA or the CaCities. Official positions of the GASB and the AICPA are reached only after extensive due process and deliberations. Professional judgment is required.

The information presented below is a high-level summary of key considerations related to GASB Statement No. 87, *Leases,* and is not all inclusive. Local governments should be sure to review the provisions of the Statement in detail to understand all components and implementation requirements.

## Purpose of this Government Industry Alert

- With the 2022 effective date issuing the GIA is easier and faster than the traditional "white paper"
- This GIA is intended to aid in implementation
- Use of Statement No. 87 and the related Implementation Guide is still required

## Highlights

In June 2017, GASB issued Statement No. 87, *Leases,* and the objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset.

## Effective Date

The provisions of this Statement and the associated Implementation Guide 2019-3 are to be implemented in financial statements with fiscal years beginning after June 15, 2021, or fiscal year 2022 and calendar year 2022.

## Implementation of GASB 87

The implementation of the provisions of this Statement could require a significant amount of staff time, both for the local government staff and for the local government's auditors. If the local government has not already inventoried its contracts/leases in place as of July 1, 2021 (or January 1, 2022), and determined which are subject to GASB 87, it is critical that the time is **now**. If the implementation is deferred until the year-end closing process, there might not be sufficient time to complete the implementation and allow the auditors sufficient time to audit this new area and issue the financial statements timely. In addition, understanding GASB 87 now is important, because events can occur during the current fiscal year or in future years that require the remeasurement of lease assets or liabilities.

### *Definition of a Lease*

A lease is defined 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.

**Summary of Key Provisions of GASB No. 87**

- Lease are financings (Foundational Principle)
- For lessees and lessors
- A single approach is required for all leases

***Steps to determine whether the contract is subject to GASB 87***

**Step 1: Contract**
Determine whether the contract is in writing or verbal and is legally binding.

a. If yes, go to step 2
b. If no, is not subject to GASB 87

**Step 2: Conveys Control**
Determine whether the lessee has the right to present service capacity from the use of the underlying assets and the right to determine the nature and manner of use of the underlying asset.

a. If yes, go to step 3
b. If no, this transaction is not subject to GASB 87

**Step 3: Nonfinancial Asset**
Determine whether the underlying asset is a non-financial asset as defined in GASB 72.

a. If yes, go to step 4
b. If no, this transaction is not subject to GASB 87

**Step 4: Exchange or Exchange Like Transaction**
Determine whether the lessee provide the lessor relative consideration in return for the use of the underlying asset.

a. If yes, go to step 5
b. If no, this transaction is not subject to GASB 87

**Step 5: Scope Exclusions**
Determine if the underlying asset falls into one of the following categories:

i. Intangible Asset
ii. Biological Asset
iii. Service Concession Arrangements
iv. Supply Contracts
v. Inventory

a. If yes, this transaction is not subject to GASB 87
b. If no, go to step 6

**Step 6: Short-term Lease**
Determine if the maximum possible lease term is 12 months or less[1], including all options to extend, regardless of whether it is reasonably certain the options will be exercised.

a. If yes, this transaction is not subject to GASB 87
b. If no, go to step 7

**Step 7: Financed Purchased**
Determine whether the transfer of ownership of the underlying asset at the end of contract and does not contain termination options (other than fiscal funding or cancellation clauses)

a. If yes, this transaction is not subject to GASB 87
b. If no, this transaction is subject to GASB 87

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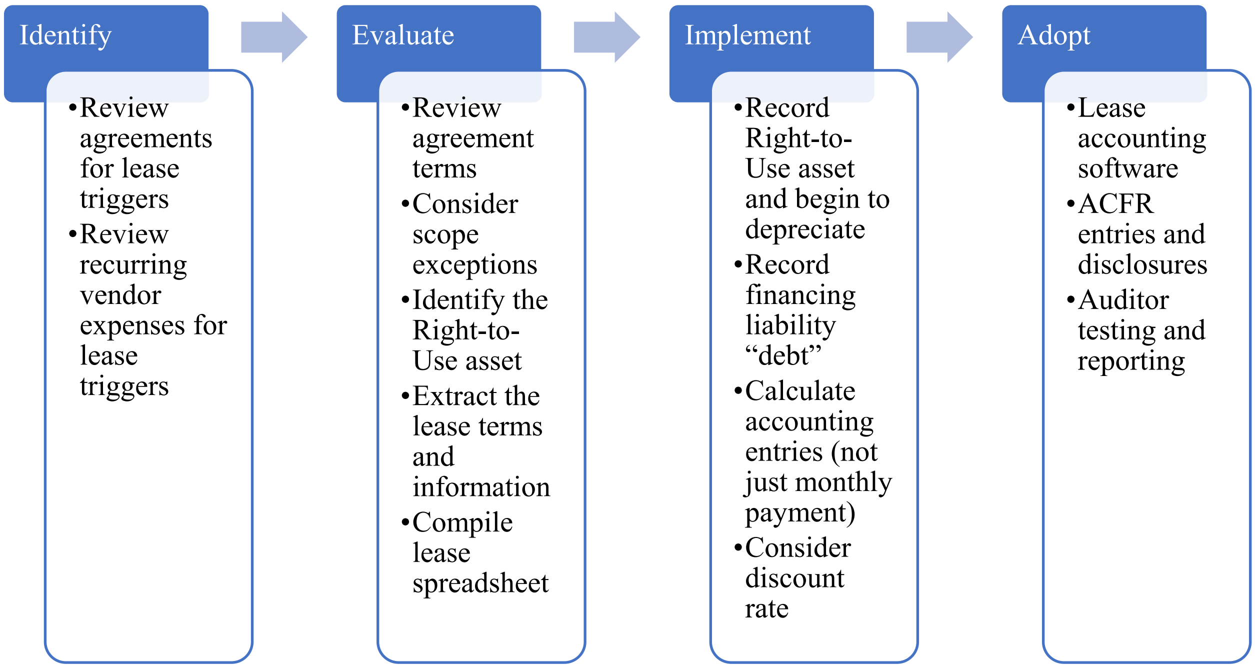
[1] For practical reason, during the first year of implementation, if the lease term expires during the implementation year, the contract can be classified as a short-term lease and is not subject to GASB 87. For example, a 10-year lease that expires on March 31, 2022 would be considered a 9-month lease as of July 1, 2021. Therefore, this contract is considered a short-term lease and is not subject to GASB 87.

**Suggested Implementation Process**




**Incremental Borrowing Rate**

If the interest rate cannot be readily determined by the **lessee**, the lessee's estimated incremental borrowing rate (an estimate of the interest rate that would be charged for borrowing the lease payment amounts during the lease term) should be used.

If the interest rate cannot be readily determined by the **lessor**, see question 4.15 of the GASB Implementation Guide No. 2020-1 for guidance on determining the discount rate to be used.

**Journal Entries**

***Initial Reporting***

| | Assets | Liability | 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 | Present value of future lease payments (incl. fixed payments, variable payments based on index or rate, reasonably certain residual guarantees, etc.) | NA |
| **Lessor** | • Lease receivable (generally including same items as lessee liability)<br>• Continue to report leased asset | NA | Equal to lease receivable plus any cash received up front that relates to a future period |

***Subsequent Reporting***

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

**Financial Statement Presentation**

The accounts noted above will be included in the financial statements. For the lessee, the intangible asset will be included as a component of capital assets and the lease liability, if not previously reported, will be included in the long-term debt/liabilities footnote. For the lessor, the lease receivable and offsetting deferred inflow of resources will be new components of the Statement of Net Position.

**Materiality**

As with any GASB pronouncement, the Statement indicates "The provisions of this Statement need not be applied to immaterial items." With that information, the local government should determine whether ***all*** lease agreements that are subject to Statement 87 should be recorded, or if the determination of whether to record those agreements should be subject to existing (or new) policies of the local government, such as the capitalization policy.

Appendix B of Statement 87, although not authoritative, includes this discussion: Some stakeholders questioned whether a government would be permitted to set a policy establishing thresholds for capitalization of its leases, similar to those commonly used for capital assets. The Board views capitalization policies as methods to operationalize materiality; that is, those policies allow governments to specify amounts that they consider to be significant, individually or in the aggregate. The Board believes that a policy similar to those that establish capitalization thresholds could be used for leases. However, establishing such a policy is within the province of management and, accordingly, is not addressed in this Statement. The Board noted, however, that the assessment of the significance of liabilities is independent of capitalization policies.

So, while it is not required that the local government use existing capitalization thresholds for determining whether lease agreements should be recorded, the cost/benefit of recording all leases versus only recording and accounting for leases over a certain dollar threshold should be considered. Therefore, the local government should establish policies and procedures related to the recording of lease agreements to ensure that there is consistency in the accounting for lease agreements and to facilitate the process of determining which lease agreements are subject to Statement 87.

Finally, prior to finalizing any policies or materiality thresholds, the local government should consider discussing the decisions with its external auditors to ensure there are no potential audit issues.

**Illustration of Calculations**

The calculation of the Initial Value of the Lease Receivable/Lease Liability can be complex, depending on the terms and conditions of the lease agreement and the "reasonable certainty" of management's decisions regarding whether to exercise options.

The initial calculation is then used as the basis for the annual amortization of the Deferred Inflow (lessor)/Lease Liability (lessee). In the example below, we provide an illustration of the information needed for the calculations. This is ***only*** an example and may not include all components subject to Statement 87. Each local government must analyze its own agreements, facts and circumstances to determine how to account for and record lease agreements.

- *Assumptions:*
    - Lease contract for a building
    - Lease commencement July 1, 2021
    - 60 month noncancelable term
    - Option to extend the lease an additional 12 months
    - Monthly payment $2,500
    - First month is free
    - Excess use charge is not applicable to this agreement
    - Lessee must pay the cost of repairs and maintenance (approximately $2,000 per year)
    - Early cancellation penalty of $2,500
    - 2.5% interest rate

- *Accounting and Reporting*
    - Lease Term
        - Noncancelable term = 60 months
        - Include option to extend?
            - Only if *reasonably certain* it will be exercised
                - Lessee is unsure of extension – therefore, Lease Term = 60 months
    - Variable payments - include excess use charge?
        - There is none for this agreement, but No – variable payments based on future performance or usage are not included.
        - Certain variable payments (paragraphs .21 and .22) should be included in the lease liability as applicable.
    - Include repairs and maintenance costs?
        - No, service components are excluded, unless not practicable
    - Include cancellation penalty?
        - Only if *reasonably certain* it will happen
            - Lessee is certain it will not cancel the lease therefore, exclude cancellation penalty
    - Include lessor incentive?
        - Yes – first month is free

In this example, we use the Excel "Present Value" formula to calculate the discounted balance.

**Initial Measurement of Lease Asset and Lease Liability**

| Payment Type | Include in Measurement? | Amount | |
|---|---|---|---|
| Base payment | Yes | $141,159 | ($2,500/month x 60 months, discounted at 2.5%) **(A)** |
| Excess use charge | n/a | | |
| Repair and maintenance | No, service components are excluded, unless not practicable. | 0 | |
| Cancellation penalties | No, management is *reasonably certain* it will continue the lease for 60 months | 0 | |
| Lessor incentive | Yes - first month is free | (2,500) | |
| | **Initial value of lease liability** | 138,659 | |
| Delivery and installation | n/a | 0 | |
| | **Initial value of lease asset** | $138,659 | |

**(A) Present Value Formula** = -PV(2.5%/12,60,2500,,1)

Depending on the timing of the start of the lease, amortization may occur during the first year of implementation.

In the above example, the lessee chooses to amortize the lease asset and the lessor chooses to amortize the deferred inflow of resources on a straight-line basis—$2,311/month ($138,659 lease asset divided by 60 months).

The balance of the lease asset and the balance of the lease liability are the same in the above example, therefore the monthly payment schedule for reducing the lease liability and lease asset in the first year is as follows:

| Date | Beginning Balance | Interest Paid | Principal Paid | Total Payment | Balance after Payment |
|---|---|---|---|---|---|
| 7/1/2021 | $138,659 | $ - | $2,500 | $2,500 | $136,159 |
| 8/1/2021 | 136,159 | 284 | 2,216 | 2,500 | 133,943 |
| 9/1/2021 | 133,943 | 279 | 2,221 | 2,500 | 131,722 |
| 10/1/2021 | 131,722 | 274 | 2,226 | 2,500 | 129,496 |
| 11/1/2021 | 129,496 | 270 | 2,230 | 2,500 | 127,266 |
| 12/1/2021 | 127,266 | 265 | 2,235 | 2,500 | 125,031 |
| 1/1/2022 | 125,031 | 260 | 2,240 | 2,500 | 122,791 |
| 2/1/2022 | 122,791 | 256 | 2,244 | 2,500 | 120,547 |
| 3/1/2022 | 120,547 | 251 | 2,249 | 2,500 | 118,298 |
| 4/1/2022 | 118,298 | 246 | 2,254 | 2,500 | 116,044 |
| 5/1/2022 | 116,044 | 242 | 2,258 | 2,500 | 113,786 |
| 6/1/2022 | 113,786 | 237 | 2,263 | 2,500 | **111,523** |
| Total Payments | | $2,864 | $27,136 | $30,000 | |

Example journal entries related to the above transaction, with the assumption that the transactions are taking place in a governmental fund (modified accrual) include:

***Lessee Entries***

- Record initial lease balance – *entity-wide entry*

| | | |
|---|---|---|
| Dr. Intangible Lease Asset | 138,659 | |
| Cr. Lease Liability | | 138,659 |

- Record lease payments (12 months) – fund level entry

| | | |
|---|---|---|
| Dr. Principal Expenditure | 27,136 | |
| Dr. Interest Expenditure | 2,864 | |
| Cr. Cash | | 30,000 |

- Record lease payments elimination entry and lease asset/lease liability adjustments - *entity-wide entry*

| | | |
|---|---|---|
| Dr. Amortization Expense | 27,732 | |
| Cr. Intangible Lease Asset (Accumulated Amortization) | | 27,732 |

| | | |
|---|---|---|
| Dr. Lease Liability | 27,136 | |
| Cr. Principal Elimination | | 27,136 |

***Lessor Entries***

- Record initial lease balance – *fund level entry*

| | | |
|---|---|---|
| Dr. Lease Receivable | 138,659 | |
| Cr. Deferred Inflow | | 138,659 |

- Record lease payments (12 months) – *fund level entry*

| | | |
|---|---|---|
| Dr. Cash | 30,000 | |
| Cr. Lease Receivable | | 27,136 |
| Cr. Interest Income (UMP) | | 2,864 |

- Record amortization of deferred inflows to lease revenue – *fund level entry*

| | | |
|---|---|---|
| Dr. Deferred Inflows | 27,136 | |
| Cr. Lease Revenue | | 27,136 |

***NOTE –*** the above journal entries are for illustrative purposes only and may not include all necessary components for each local government's transactions.

**Footnote Disclosures**

Disclosure requirements vary from lessee to lessor and include:

- ***Lessee***
  - General description of leasing arrangements, including:
    - The basis, terms and conditions on which variable payments not included in the measurement of the lease liability are determined
    - The existence, terms and conditions of residual value guarantees provided by the lessee not included in the measurement of the lease liability
  - Total amount of lease assets, related accumulated amortization (disclosed separately from other capital assets)
  - Amount of lease assets by major classes of underlying assets (disclosed separately from other capital assets)
  - Amount of variable payments not previously included in the measurement of the lease liability
  - Amount of 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 for each of the next five years and in five-year increments thereafter
  - Commitments under leases before commencement date
  - Impairment loss and any related change in lease liability
  - If applicable, additional disclosures are required for sublease transactions, sale-leaseback transactions and lease-leaseback transactions

- ***Lessor***
  - General Description of leasing arrangements, including the basis, terms and conditions on which variable payments not included in the measurement of the lease receivable are determined
  - Amount of inflows of resources recognized (lease revenue, interest revenue and any other lease-related inflows), if amount cannot be determined on the face of the financial statements
  - Amount of inflows of resources recognized for variable and other payments not previously included in lease receivable, including inflows of resources related to residual value guarantees and termination penalties
  - Existence, terms and conditions of lessee options to terminate lease or abate payments if the lessor has issued debt which is secured by lease payments
  - If applicable, additional disclosures are required for leases of assets that are investments, certain regulated leases, sublease transactions, sale-leaseback transactions and lease-leaseback transactions
  - If the lessor's principal ongoing operations consist of leasing assets to other entities, include a schedule of future payments that are included in the measurement of the lease receivable for each of the next five years and in five-year increments thereafter

- ***Both –*** the Summary of Significant Accounting Policies (SSAP) may need to be revised for:
  - Modification of basis of accounting
  - Modification to capital assets policies
  - New lease policy
  - Additional deferred outflows/inflows of resources components

Other than the SSAP revisions, the above disclosures could be included in a new Leases note disclosure or added to the existing capital asset/long-term debt or commitments disclosures, as applicable. In addition, when a local government has a significant number of lease transactions to disclose, Statement 87 provides for the aggregation of similar leases to simplify the information presented.

Paragraphs 37 (Lessee) and 57 (Lessor) of Statement 87 should be consulted to ensure that all disclosure requirements are met. Detailed disclosure examples are available online, such as in the Government Finance Officers Association's Example Annual Comprehensive Financial Report.

**Other Considerations**

The discussion above focuses on the first year of implementation. However, the local government should also establish a system/process for ongoing monitoring, tracking and accounting for leases. New leases issued throughout the fiscal year should be added to the overall lease inventory records and analyzed for accounting under the provisions of Statement 87, and modifications to existing leases must be reviewed to determine whether remeasurement is necessary. The implementation of Statement 87 and analysis of lease agreements is not a one-time event – the process will continue each fiscal year. Therefore, processes and procedures must be in place to ensure that agreements or transactions are not overlooked.

**In Conclusion of GASB No. 87 GIA**

- Key data is required from every lease
- Use updated "materiality thresholds" from capitalization policy
- Accounting for lessees and lessors required
- Create a process to manage new leases and changes to existing leases (Internal Control)
- Determine management and accounting for all leases