



ACCOUNTING

Are We There Yet?

Implementing GASB 87 for existing lease contracts.

BY MICHELE MARK LEVINE

Sometimes anticipation is the worst part of a dreaded event, and perhaps this will be the case with the implementation of the Governmental Accounting Standards Board Statement No. 87, *Leases* (GASB 87). GASB 87 is first due to be implemented by governments for their earliest fiscal years beginning after June 15, 2021, but it might seem to you that we've been talking about this statement for a long time. We started out with a generous implementation period for GASB 87, which was originally scheduled to become effective for periods two and a half years after issuance. Then, due to COVID-19, GASB granted an 18-month postponement for GASB 87—based on pleas for mercy from governments—even while permitting only a one-year deferral for other pronouncements. This resulted in an unusually long total

lead time between the promulgation of the standard and its required implementation. The good news is that during this extended period, GASB provided lots of implementation guidance to help, and GFOA has discussed the new accounting for leases in many articles, conference sessions, and webinars.

Many governments are now well into the fiscal years for which they will first issue GASB 87-compliant financial statements. Having completed (or nearly so) the process of identifying contracts that are or include leases, many governments are now facing the devil in the details of implementation. Specifically, many are pondering how to (1) determine the lease terms; (2) classify leases as short-term or other than short-term leases; (3) calculate (or measure, in GASB parlance) lease liabilities and lease assets (for lessees), and lease

receivables and deferred inflows or resources (for lessors); and (4) prepare the necessary journal entries for preexisting leases at transition.

To answer some of the questions, let's think about an example of a lease that predates implementation. A complete set of assumptions and questions and answers about the implementation for such a lease from the perspectives of governments on both sides of the transaction, along with an Excel file containing calculations and journal entries for the implementation, are available on GFOA's website at gfoa.org/materials/lease-example-preexisting. This article will discuss questions and answers generally, from the lessee's perspective, but you'll have to go to the website to see the numbers and the answers to many of the same questions from the lessor's perspective.

The basic assumptions for our example are the following:

- A city with a June 30 fiscal year end (FYE) leases a building to house certain administrative functions.
- The 10-year lease term began on July 1, 2012 (initial inception) and will end on June 30, 2022.
- The lease is accounted for in the city's general fund and was originally properly accounted for as an operating lease, based on pre-GASB 87 generally accepted accounting principles.
- The rent is paid annually on July 1 for the July to June year. The rent payment was set in the contract at a specific dollar amount for the first year, and thereafter each year's rent is adjusted by the change in a price index for similar property in the region, making this a variable lease payment.

- The lease contract does not contain a stated interest rate, nor does the city know what rate the landlord is charging. The city concludes that it is not able to impute an interest rate, so it will use its incremental borrowing rate as the discount rate for calculating the present value of future lease payments.

Assuming that the city didn't early implement, it must first report in accordance with GASB 87 in its financial statements prepared for FYE June 30, 2022. However, GASB 87 tells us that changes made to implement the standard should be made "retroactively by restating financial statements, if practicable, for all periods presented."¹ Additionally, the transition guidance tells us that "Leases should be recognized and measured using the facts and circumstances that existed *at the beginning of the earliest period restated*"² (emphasis added). That means the lease term and the measurement of the lease liability and lease asset will all be based on facts and circumstances as if a lease term begins on July 1 of—wait. Of which year?

The answer depends on whether the city issues single-year or comparative financial statements for FYE 2022. If single-year statements are presented, then the assumed start of the lease term for will be July 1, 2021, the first day of FYE 2022.³ On the other hand, if the city will issue two-year comparative financial statements for FYE 2022, the assumed lease term begins July 1, 2020, the first day of FYE 2021.

Next question: What is the term (length) of the lease? Assuming that, as of July 1 of the appropriate year (as just discussed), there are no remaining extension, purchase, or termination options that could affect the term (see further discussion of

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these options, below), then June 30, 2022, will be the end date of the lease term. An assumed inception date of July 1, 2021—the one that would be applicable if the city issues only single-year financial statements—is not more than a year before the lease term ends, making this a short-term lease. If that's the case, applying GASB 87 will be virtually the same as continuing the prior accounting for an operating lease, and no restatement will be needed. However, if the city issues comparative financial statements, the assumed inception date of July 1, 2020, is more than a year before the June 30, 2022, term end, and then we have some more work to do! The remainder of this discussion will assume that comparative statements are going to be issued.

If you're thinking that assuming a July 1, 2020, inception date means that we are going to be measuring the lease liability using assumptions that we will likely know already are "wrong," then you are right! Most notably, in the case of our example, the index that will be applied to calculate the amount of the variable lease payment due on July 1, 2021, will be measured based on the index that had been applicable to the



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Examples of Lease Implementation based on GASB 87

Visit gfoa.org to review examples of lease transactions and events based on Governmental Accounting Standards Board (GASB) Statement 87, *Leases*, as amended and expanded on by subsequent GASB pronouncements through August 2021.

The examples are available for download at gfoa.org/materials/lease-example-preexisting.

July 1, 2020, payment, despite the actual amount of the July 1, 2021, payment already being known, and likely paid, at the time of the measurement. Similarly, the city's incremental borrowing rate, which will be used as the discount rate in measuring the lease liability, should be the city's estimated rate as of July 1, 2020.

What about other aspects of the lease agreement that could affect measurement? For instance, what if—way back when the lease began on July 1, 2012 (as opposed to this assumed inception date of July 1, 2020, for our GASB-87-compliant lease)—there had been one or more of the following provisions:

- Extension, termination, or purchase options?
- Additional payments such as for a portion of the landlord's building insurance, maintenance costs, or taxes, that are required by the contract to be made by the city each year?

- Prepayments, such as for the last period's rent, made by the city upon initial inception?
- A damage deposit made by the city upon inception?
- Concessions from the landlord?

Let's look at these one at a time.

Extension, termination, and purchase options.

In determining the term of the lease, as hinted at above, only those extension, termination, and purchase options that remain as *options* as of the assumed implementation date are treated as options.⁴ Any option in the preexisting lease contract that had already been exercised would no longer be an option, but it would affect the lease's noncancellable period.^{5,6} Any option that had already expired should simply be ignored. For those that remain options, the probability of their exercise that should be used to determine the options' effects, if any, on the lease term (for example, if extension and purchase options are reasonably certain to be

exercised, or if termination options are reasonably certain *not to be* exercised) should be the probability that would have been assigned as of the assumed implementation date of July 1, 2020.⁷

Additional payments. Insurance, taxes, and maintenance costs are non-lease components of a contract and are not included as future lease payments in the measurement of the lease liability. They should be treated as expenditures/expenses of the period to which they relate.⁸


Prepayments. In government-wide financial statements, a prepayment made by the city to the landlord on July 1, 2012, would have been being reported by the city as an asset in its government-wide financial statements prior to implementing GASB 87. Upon implementation, that separate asset should be derecognized and its value become part of the lease asset, which would be amortized over the remaining lease term. The general fund treatment of a prepayment will depend on whether the city had initially reported it as an additional expenditure for FYE 2013 when paid (using the purchase method of accounting for prepaid items), or if the city had carried it as a prepaid item in its general fund since inception (using the consumption method of accounting for prepaid items). If the former, the prepayment will be ignored in the general fund accounting upon transition, and the amount of the general fund debt service expenditure in the final year would only be the amount actually paid that year. (See the additional discussion of governmental fund recognition, below).

Damage deposits. The accounting for a damage deposit would be unaffected by GASB 87. The deposit should continue to be carried as an asset in both the general fund and government-wide, until it is returned. If damages occur for which the deposit will be reduced, the expenditure/expense should be recognized, and the

deposit asset reduced, in the period in which the damage occurs or when it becomes known, if later.

Concessions. Original concessions, if any, received by the city before the assumed July 1, 2020, inception date need not be included in measurement (as a reduction) of the lease asset upon implementation, as it will not affect any future payments. However, if an initial concession were being amortized over the life of the original operating lease, the unamortized amount would be derecognized and included as a reduction to the lease asset as of the assumed inception date of the GASB 87-compliant lease. Any concessions yet to be received by the city should be considered when measuring the future lease payments, as an offsetting reduction of payments in the period(s) when they will be received, thereby reducing amount of the lease liability and lease asset.

Finally, let's look at how the transition would be recognized in a governmental fund. For a lease other than a short-term lease, a governmental fund recognizes an expenditure (capital outlay) in the amount of the lease asset. However, while this article refers to the beginning of the earliest period restated as an assumed lease term inception date, GASB 87 itself only identifies it as being the "as of date" for recognizing and measuring the lease liability and lease asset, leaving the governmental fund recognition unspecified. Therefore, arguably, that treatment at transition is optional.⁹

Please do take the time to review the detailed illustration based on this example—at gfoa.org/materials/lease-example-preexisting—that serves as a companion to this article because, while we're not *there* yet, *there* is just around the corner from *here*. 

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¹ GASB 87, paragraph 93.

² GASB 87, paragraph 94.

³ As will be discussed later in this article with regard to governmental fund recognition, GASB has identified the beginning of the first period being restated as the date upon which the GASB-87-compliant lease should be recognized and measured. For this discussion, however, it is helpful to think of that as being the inception date of a new lease.

⁴ GASB has issued an Exposure Draft, titled Omnibus 20XX, (Omnibus ED) which proposes to clarify that for the purpose of determining lease term, termination options exclude those that are conditional, such as on the noncompliance of the other party to the lease contract (Omnibus ED, paragraph 11.a.).

⁵ The Omnibus ED proposes that the lease term exclude periods after the assumed exercise of a purchase option (Omnibus ED, paragraph 11.b.). As this proposal seems a logical necessity, its adoption is assumed here.

⁶ If a purchase option has already been exercised, such that the purchase by the lessee has become contractually required as of the assumed implementation date, even if the purchase itself will take place (or did take place) after that date, the lease would be accounted for as a contract that transfers ownership, in accordance with GASB 87, paragraph 19, and GASB Implementation Guide No. 2020-1, question 4.8.

⁷ Of course, unless such an assessment had been made on that day, hindsight might possibly highlight the importance of information that was already available on July 1, 2020, for use in making the assessment.

⁸ GASB Implementation Guide No. 2021-1, question 4.11.

⁹ A government could instead recognize a capital outlay only of the amount actually paid in that first year, plus any prepayments that had been being reported in the general fund (in order to derecognize them), rather than also recognizing another financing source in the amount of the lease liability.