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Prepare Today for the New GASB Lease Accounting Standard: Five Steps to Implementation

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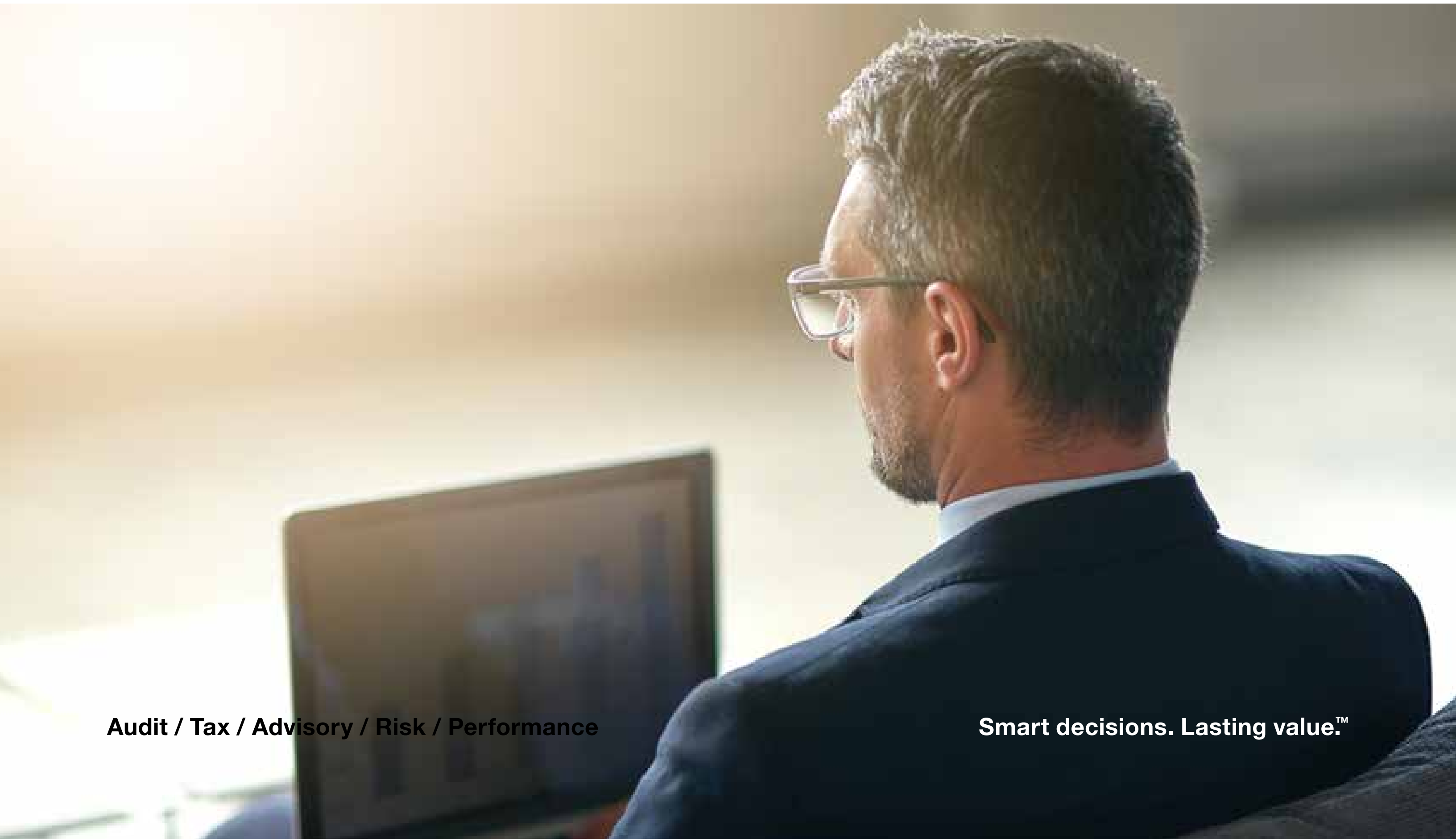

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The recently issued Governmental Accounting Standards Board (GASB) Statement No. 87 will alter the way entities account for lease transactions in ways that will have wide-ranging effects on organizations' accounting and information technology systems.

While the standard does not become effective until reporting periods after Dec. 15, 2019, organizations should begin preparing today. Coming into compliance will require a detailed evaluation of all lease agreements and contractual arrangements (not just copy machines but also large items like land and building leases), as well as internal control process updates. Once such processes are in place, the establishment of new monitoring procedures is imperative.

Leases Redefined

Previous guidance defined leases as either capital or operating, and while capital leases were recognized in financial statements, operating leases were not, aside from a monthly expense for rent payments. Under GASB 87, all leases are to be recorded on the financial statements, for both lessors and lessees. The underlying principle is that all leases, which have been redefined as contracts that convey control of the right to use another entity's nonfinancial asset, are financing instruments of the right to use that same underlying asset for a period of time.

Essentially, the concept of the operating lease is going away, and in most cases, entities will have to report lease agreements in their financial statements.

When GASB 87 is effective, lease obligations will be offset by an intangible asset (for leases previously called operating leases).

The following exhibits provide a brief overview of the approaches for leases under the new standard:

Exhibit 1: Leases Overview – Initial Reporting

	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	Present value of future lease payments (including fixed payments, variable payments based on index or rate, reasonably certain residual guarantees)	Not applicable
Lessor	• Lease receivable (generally including same items as lessee liability) • Continue to report leased asset	Not applicable	Equal to lease receivable plus any cash received up front that relates to a future period

Source: GASB

Exhibit 2: Leases Overview – Subsequent Reporting

	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)	Not applicable
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)	Not applicable	Recognize revenue over the lease term in a systematic and rational manner

Source: GASB

The new standard excludes certain types of transactions, and thus they will not be treated as leases. Exclusions include specifically:

- Leases of an asset with a term shorter than one year, such as a period of six months, entirely contained within a single fiscal year
- Intangible assets for which the nature of the asset is distinct from tangible assets, such as cloud computing software, copyrights, or patents
- Subleases
- Biological assets and inventory
- Service concession arrangements, addressed in GASB 60
- Assets financed with outstanding conduit debt
- Supply contracts with public utilities

Lease Terms Are Significant

GASB 87 is unique in its emphasis on lease terms. The definition of the lease term will thus take on greater importance, as financial reporting is based on when the lease term starts and ends. The 12-month exclusion offers just one example.

The importance of carefully defining the lease term is evident for cases in which leases have embedded options either to extend or terminate the lease period. For example, a five-year lease would include a noncancelable period of five years. Any options to extend or terminate outside of that five-year period would be included in the noncancelable period only if they are reasonably certain to be exercised. Similarly, if periods arise when either the lessee or the lessor has the option to terminate or extend, such as in the case of a rolling month-to-month lease, those periods will be excluded.

Diligence Is Critical

Compliance with GASB 87 will require a thorough and detailed evaluation of existing arrangements as well as careful, ongoing monitoring of lease agreements.

Entities will need to evaluate current agreements with vendors to determine if any would be considered a lease situation under the new standard. Contractual arrangements that involve recurring payments for certain services, materials, or supplies might lead to a lease in some cases. Alternatively, leases currently paired with contractual arrangements must be examined: for example, in the case of a copier lease that includes a repair and maintenance contract, entities need to understand which part of the agreement is truly a lease and which part simply requires the recording of payments without an asset or liability.

Once in effect, GASB 87 will also necessitate more regular monitoring of lease agreements, as lease modifications, terminations, and sale-leaseback transactions will have a major impact on the treatment of leases. If a modification of a lease term takes place, for example, the recorded liability and asset will need to be remeasured over the remaining adjusted useful life and term of the liability and asset.

While equipment leases generally do not change drastically, building leases that last for a period of multiple years, or even decades, could very well undergo modification based on significant improvements to the leased space, or modification of the term or lease amount. Entities that fail to monitor such situations adequately might find themselves in situations in which financial reporting errors could occur.

During the year of implementation of GASB 87, organizations will be required to restate prior-year periods in the cases of material adjustments. For leases previously considered operating, an asset will have to be recorded as of the beginning of the lease period, offset with a liability with the remaining piece shown as an adjustment to prior periods. For subsequent years in which an asset is being amortized over its useful life and an identical liability is being paid down, the difference will not be material, and a simple, current-year income statement adjustment will be adequate.

Accounting Treatment Is Only the Beginning

While for some standards early implementation is discouraged or even prohibited, in the case of GASB 87, entities are encouraged to apply the standard before the effective date.

To come into compliance, entities will need to do a thorough cataloging of current lease agreements and contractual arrangements. Having completed the assessment of the proper accounting treatment, entities will then need to review their software platforms, as they might need to modify general ledger accounts to create new account codes for leases. They might also need to change internal controls to apply those previously used on capital leases to new leases being reported for the first time.

Five Steps for Implementation

Because this evaluation and preparation process will be lengthy for some entities, organizations should start as soon as possible. This five-step framework illustrates the first steps entities can take to begin the process.

Appoint a Champion	An implementation champion can spearhead the process and make sure all proceeds as smoothly as possible. Important considerations for selecting this individual will include: Does this individual have the necessary skills in organization of large complex projects and technical expertise in the new standard as well as prior reporting requirements? Does the individual have the capacity to devote the time necessary to complete the implementation? Finally, does the individual have access to the resources needed to be successful?
Create a Task Force	GASB 87 is not a standard that can be implemented in a finance department bubble. Finance staffers will need to interface with individuals in the operations function who might have originated the leases, and also with legal counsel, who might have lessor templates in place that require review and updating. Responsibilities of the task force will include identifying current policies and procedures affected by the change, reviewing impact on debt covenants, documenting internal controls to verify proper accounting and financial reporting, and determining repository locations for lease terms and necessary information for implementation and subsequent periods.
Inventory the Lease Population	This step will be one of the most time-consuming components of the implementation process. Lease agreements can be in excess of 100 pages long, and even a small municipal entity could have numerous leases on the books – all of which underscores the importance of starting the process as soon as possible. Entities should compile a list of all leases, considering prior years; gather lease agreements; identify primary parties of the lease agreements to clarify any ambiguous terms in the leases; document lease term and main assumptions; and finally, reconsider whether leases are necessary and most advantageous to the organization.
Consider Change Management	Organizations must consider any types of changes that would lead to new measurements or accounting for leases, such as period changes, refinance arrangements, and incorporation of leasehold improvements into existing agreements. Entities should also identify any triggering events that could prompt reevaluation of lease accounting, such as impairment, changes in lease term, or significant changes in assumptions.
Communicate With Stakeholders	Finally, entities must provide visibility and transparency to stakeholders, educating them on the impact of the lease standard and managing expectations regarding new presentation of the former operating leases. External stakeholders, such as rating agencies and lenders, should be identified and included in communications about accounting changes, including the impact on debt ratios that could result from the addition of a large number of new liabilities formerly recorded only in footnotes as operating leases. Organizations will need to determine whether any leases need to be renegotiated based on the new standard.

Begin Now

Early action on evaluating your leases and contractual agreements will lead to a smoother implementation process and reduced stress down the road. Start preparing today.

Learn More

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