Leases Implementation Example – Preexisting Lease Contract

<u>Overview – For Illustration Only</u>

What follows are 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 assumptions, methods of estimation, and other factors regarding the recognition and measurement of various aspects of the transactions are not necessarily the only acceptable or the best options.

GFOA urges all governments to carefully consider all aspects of their own actual or contemplated transactions, apply their best professional judgement to their unique facts and circumstances to determine the most appropriate application of generally accepted accounting principles (GAAP), and consult with their independent auditors and other appropriate parties (including, as applicable, state government oversight authorities and grantors) before making significant accounting and financial reporting decisions. These are especially important with regard to transactions and events that are new to the government and/or that are the subject of newly-implemented GAAP.

Throughout these examples slight differences in amounts may result from rounding adjustments made in order to illustrate calculation results in whole dollars.

Assumptions – Upon Inception

- The Sample City (City, Lessee) leases an unused school building (Building) from the Example Independent School District (District, Lessor). The Building will be used for the City's computer center and as offices for its finance department's "back-office" operations, and contains large mainframe computers and network servers.
- The District is not part of the City's financial reporting entity.
- The City and the District:
  - Have 6/30 FYEs
  - Account for the lease in their general funds
- Lease term:
  - A noncancelable 10-year period, 7/1/2012 to 6/30/2022.
  - The City has the (unilateral) option to extend the lease term for an additional 10-years, through 6/30/2032. The option expires on 6/30/2020.
  - Based on the following considerations, the City and the District each independently determine that it is reasonably certain that the City will exercise its extension option:
    - ♦ The City and District estimated that the cost of relocating at the end of the noncancelable period would be high, likely over $300,000.
    - ♦ The City had assessed other options prior to entering into this lease contract and found this to be the most economical.

        - ♦ At the time of lease inception, neither party had any reason to believe that the real estate market or computing environments would change over the noncancelable term in a way that would diminish the likelihood of extension.

- Annual rent of $120,000/year is adjusted by the amount of the change in the Commercial Property Price Index (CPPI) for the region as of June 15th, and paid on 7/1 of each year.
- In addition to the rent, the contract specifies that City will pay a portion of the District's annual premium for specified insurance coverage it obtains through a District-wide master property insurance policy, based on the Building's share of the Districts total covered building space. The insurance payment for 7/1/2012-6/30/2013, paid on 7/1/2012, was $18,000.
- Payment upon inception is comprised of:
    - First and last years' base rent ($120,000) and
    - A $50,000 refundable damage deposit
- To help defray costs of canceling a preexisting lease, the District had paid the City $10,000 (a lessor concession) when the lease contract was signed, in January 2012
- The lease contract does not specify an interest rate, the District had based lease payments on its incremental costs, not on a predetermined interest rate, and neither party is able to impute an interest rate based on readily available information. Thus each uses its own estimated incremental borrowing rate as the discount rate when calculating the PV of future lease payments. The City's and the District's incremental borrowing rates as of 7/1/2012 were 2% and 1.95%, respectively

Assumptions – Subsequent Events Summary

Payment / Event Date	**Cumulative Change CPPI**	**Indexed Rental Payment**	**Proportionate Share of Insurance**	**City's Incremental Borrowing Rate**	**District's Incremental borrowing rate**
7/1/2019	40.00%	$168,000	$24,000	2.45%	2.30%
6/30/2020		Extension option expires unexercised‡			
7/1/2020	18.33%□	$142,000	$24,500	1.75%	1.65%
7/1/2021	24.95%	$29,940*	$25,000	1.80%	1.75%
6/30/2022	30.00%	n/a	n/a	2.15%	2.15%

* 7/1/2021 final payment was reduced by the $120,000 base rent paid in advance at inception

‡ In 2020, the City decided to move its financial systems to a cloud computing environment and have most of its back-office operations staff work remotely. It expects that this

transition can be completed before the end of the initial lease term, and therefore does not exercise its option to extend the lease, which then expired on 6/30/2020.

▫ A major disruption in the commercial real estate market occurred and caused a significant year-over-year decline in CPPI as of June 15, 2020. [Can't imagine what that might have been…]

Implementation Questions (City, Lessee):

1. If the City *does not* elect to early implement GASB Statement No. 87 (GASB 87), in what year will it first recognize the effects of implementing GASB 87?
   [Answer: In financial statements prepared for FYE 6/30/2022]
2. If the City does not prepare comparative financial statements, how should it implement GASB 87?
   [Answer: As a short-term lease, final payment made 7/1/2021 is an expenditure/expense of the period]
3. If the City prepares comparative financial statements, how should it implement GASB 87?
   [Answer: Restate FYE 6/30/2021 financial statements presented in financial statements prepared for FYE 6/30/2022]
4. If the City prepares comparative financial statements, in implementing GASB 87 for this lease, what are the:
   a. Amounts of the rental payment (i.e., using the CPPI as of what date), if any, that should be included in the calculation of the lease liability upon implementation?
      [Answer: All future payments based on CPPI as of 7/1/2020, the first day of the first fiscal year restated and the assumed start date of the lease term when transitioning]
   b. Amounts of the insurance payment, if any, should be included in the calculation of the lease liability upon implementation?
      [Answer: None. This is a non-lease component of the contract that also contains the lease, and should be accounted for as an expenditure/expense in the period for which the cost is incurred]
   c. The estimated incremental borrowing rates (i.e., as of what date) that should be used for the calculation of the lease liability upon implementation?
      [Answer: the City would use its estimated incremental borrowing rate as of 7/1/2020, the first day of the first fiscal year restated and the assumed start date of the lease term when transitioning]
   d. The effect, if any, of the prepayment of the final year's base rent that was made upon inception of the lease, on the measurement of the lease liability and lease asset upon implementation?
      [Answer: As this will affect the amount of the final lease payment, it should be factored into the calculation of the lease liability by reducing the value of future

payments for which a present value is calculated, and into the lease asset, as an addition.]

e. The effect, if any, of the concession previously received by the City from the District, on the measurement of the lease liability and lease asset at transition?
[Answer: There is no precise guidance provided by GASB on this point. Both of the following approaches seem reasonable: (i) ignore the effect of the concession and base the measurement of the lease asset of resources on only the lease liability and the prepayments that will affect payments made on 7/1/2020 and later, or (ii) deduct the amount of the concession allocable to the remaining period of the lease when measuring the lease asset, as would have been done at the inception if GASB 87 had been in effect.]

Implementation Questions (District, Lessor):

5. Making the same initial and subsequent assumptions specified for the City, and assuming that the District prepares comparative financial statements in implementing GASB 87 for this lease, what are the:
   a. Amounts of the rental payment (i.e., using the CPPI as of what date), if any, that should be included in the calculation of the lease receivable?
   [Answer: Same as for lessee's calculation of the lease liability]
   b. Amounts of the insurance payment, if any, should be included in the calculation of the lease receivable?
   [Answer: None. As a non-lease component of the contract, the revenue will be recognized in the period to which it relates]
   c. The estimated incremental borrowing rates (i.e., as of what date) that should be used for the calculation of the lease receivable?
   [Answer: Same as for lessee's measurement of lease liability]
   d. The effect, if any, of the prepayment of the final year's base rent that was received upon inception of the lease, on the measurement of the lease receivable and deferred inflow of resources upon implementation?
   [Answer: As this will affect the amount of the final lease payment to be received, it should be factored into the calculation of the lease receivable by reducing the value of future payments for which a present value is calculated, and into the deferred inflow of resources, as an addition.]
   e. The effect, if any, of the concession previously paid to the City, on the measurement of the lease receivable and deferred inflow of resources at transition?
   [Answer: There is no precise guidance provided by GASB on this point. Both of the following approaches seem reasonable: (i) ignore the effect of the concession and base the measurement of the deferred inflow of resources on only the lease receivable and the prepayments that have an impact on payments

that will be made on 7/1/2020 and later, or (ii) deduct the amount of the concession allocable to the remaining period of the lease when measuring the deferred inflow of resources, as would have been done at the inception if GASB 87 had been in effect.]

See Excel workbook for illustrations of calculations and journal entries for restated FYE 6/30/2021 and for FYE 6/20/2022.