

Deeper Dive – Leases

Presented by:
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Overview

- Effective dates
- Big picture
- Objective, impact, and implementation
- Applicability and definition
- Initial recognition
 - Lease terms
 - Payments
 - Interest rate
 - Asset
- Reassessment and modifications



Overview (Continued)

- Short-term leases
- Implementation strategies
- Bonus slides
 - Lessor accounting
 - Related party leases
 - Subleases
 - Component units
 - Disclosures



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FASB and GASB

- FASB – applies to not-for-profit and for-profit entities
- GASB – applies to governmental entities
- The overall substance and impact of both standards are similar, but there are differences in the details



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Effective Dates — GASB

- Fiscal years beginning after December 15, 2019:
 - December 31, 2020
 - June 30, 2021
 - September 30, 2021



Effective Dates — FASB

- Fiscal years beginning after December 15, 2019, (for most organizations):
 - December 31, 2020
 - June 30, 2021
 - September 30, 2021



Effective Dates — FASB (Continued)

- Fiscal years beginning after December 15, 2018, for any of the following:
 - A public business entity (excluding not-for-profit and employee benefit plans)
 - A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market
 - An employee benefit plan that files financial information with the SEC



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Effective Dates — FASB (Continued)

- Not-for-profit business entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market
- Indicators
 - Debt issued by a state or local governmental entity for a specific third-party (the conduit bond holder)
 - Entity reports to Electronic Municipal Market Access (EMMA)



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Big Picture

- Organizations will recognize lease assets and lease liabilities on the balance sheet for all leases
- Balance sheet will change
 - More property
 - More debt
- Net income will not change significantly
 - Classification changes among lease, depreciation and interest expense



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Objective

- To increase transparency and comparability among organizations
- Foundational principle that leases are financing of the right to use an underlying asset
 - Operating leases are currently “off-balance” sheet financing
 - Operating lease obligations will become liabilities on the balance sheet



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Improved Lease Accounting

- More faithful representation of a lessee's rights and obligations
- Fewer opportunities for organizations to structure leasing transactions to achieve a particular outcome on the balance sheet
- Improves understandability and comparability of financial statements
- Aligns lessor accounting and sales and leaseback accounting with revenue recognition standard
- Provides financial statement users with additional information about lessors' leasing activities, exposure to credit risk, and asset risk
- Clarifies definition of a lease to improve guidance and align the concept of control more closely with control principle used in revenue recognition and consolidations

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Why Lease?

- Gain access to capital
- Obtain financing
- Reduce exposure to risk of full ownership of underlying assets
- Obsolete before fully depreciated
- Intend to use for a shorter period than its useful life

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Financial Ratios

- Debt to Equity – the debt to equity ratio will increase (more liabilities with no change in equity)
- Return on Assets – the return on assets ratio will decrease (more assets with no additional net income)
- Working Capital – the working capital ratio will decrease (more current liabilities for current portion of lease liability)

Debt Covenants

- Will increase assets and liabilities on the balance sheet
- No significant impact on net income
- Need to prepare pro forma debt covenant calculations to determine any potential compliance issues – then work with creditor to modify
- Creditors will understand

Implementation

- Questions about unique transactions encouraged
- We want to know what we might not know
- DZA can take care of most accounting changes for auditees during financial statement preparation – but not with leases
- The lease accounting standard change is going to require proactive data gathering



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GASB/FASB — Applicability

- All leases and subleases of property, plant, and equipment
- Not applicable to:
 - Leases of intangible assets
 - Leases to explore for or use nonregenerative resources such as minerals, oils, and natural gas
 - Leases of biological assets, such as timber
 - Leases of inventory
 - Leases of assets under construction
 - *Leases in which the underlying asset is financed with outstanding conduit debt, unless both the underlying asset and conduit debt are reported by the lessor – GASB only*

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GASB — Lease Definition

- 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 exchange or exchange-like transaction.
- A contract that conveys control of the right to use the underlying asset should have both of the following:
 - Right to obtain the present service capacity
 - Right to determine the nature and manner of use



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FASB — Lease Definition

- A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration



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FASB — Identifying a Lease

- Lease contract
- An identified asset
 - Explicitly or implicitly specified
 - Supplier has no practical ability to substitute, and would not economically benefit from substituting the asset
- The right to control the use during the lease term
 - Decision-making authority over the use of the asset
 - Ability to obtain substantially all economic benefit from the use of the asset

FASB — Identifying a Lease (Continued)

- Determine whether a contract is a lease
 - Could be an “embedded” lease
 - Look for implicitly identified assets
- **Substitution rights**
 - Supplier has practical ability to substitute an alternative asset
 - Supplier would benefit economically from using the right to substitute the asset

FASB — Identifying a Lease (Continued)

- **Right to control** to direct the use of the asset through the period of use in either of the following situations
 - The entity has the right to direct how and for what purpose the asset is used throughout the period
 - Decisions about how and for what purposes the asset will be used are predetermined, and at least one of the following conditions exist:
 - The entity has the right to operate the asset (or direct others to operate) throughout the period of use without the supplier having a right to change those operating instructions
 - The customer designed the asset (or specific aspects of it) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

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FASB/GASB — Separating Lease and Non-Lease Components

- Many contracts contain a lease component and non-lease components
 - Maintenance agreement
 - Supplies
 - Training
 - Services
- In practice, these contracts have largely been ignored because they have been a current expense regardless of classification (lease expense or purchased service or supplies – no impact on balance sheet or income statement)

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FASB/GASB — Separating Lease and Non-Lease Components (Continued)

- Lease component now needs to be capitalized – an asset and liability will need to be recognized
- Allocated based on “stand-alone” prices
- If components cannot be separated, the entire contract is considered a lease



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GASB — Lease Accounting – Balance Sheet

- Intangible right to use asset (aka capital asset)
- Lease liability



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FASB — Lessee Accounting – Balance Sheet

- Right-of-use asset
- Lease liability
- Finance AND operating leases
- Finance and operating leases must be separately presented on balance sheet or in the notes

FASB — Lease Accounting – Income Statement

- Finance
 - Amortization expense (of right-of-use asset)
 - Interest expense
- Operating
 - Single lease expense on the straight-line basis

FASB — Lease Accounting – Cash Flow Statement

- Finance
 - Principal – financing activity
 - Interest – operating activity
- Operating
 - Lease – usually operating activity

GASB/FASB — Initial Recognition

- Lease liability at the present value of the lease payments not yet paid, using the discount rate for the lease
- Right of use asset
- Same as how capital leases are recognized currently

GASB vs FASB

- GASB uses a single model – all leases are accounted for the same
- FASB still has some distinctions between a finance and operating lease



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FASB — Finance Lease

- Classified as a finance lease when it meets any of the following criteria:
 - Ownership of the underlying asset transfers to lessee by the end of the lease term
 - Lease grants lessee an option to purchase the underlying asset the lessee is reasonably certain to exercise
 - Lease term is the major part of the remaining economic life of the underlying asset
 - Present value of the sum of the lease payments and any residual value guarantees by the lessee equals or exceeds substantially all of the fair value of the underlying asset
 - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

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FASB — Finance Lease (Continued)

- Formerly known as a “capital” lease
- Similar criteria except for no “bright lines”
 - No 75% of useful life and 90% minimum lease payment thresholds
 - Although these could be “one reasonable approach”
- “Bargain purchase option” term is not used
- Additional criteria for a specialized asset



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FASB — Operating Lease

- All other leases



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GASB — Lease Term

- Noncancelable period of the lease plus the following:
 - Periods covered by lessee's option to extend the lease *if it is reasonably certain, based on all relevant factors, that the lessee will exercise the option*
 - Periods covered by a lessee's option to terminate the lease *if it is reasonably certain, based on all relevant factors, that the lessee will **not** exercise the option*
 - Periods covered by a lessor's option to extend the lease *if it is reasonably certain, based on all relevant factors, that the lessor will exercise the option*
 - Periods covered by the lessor's option to terminate the lease *if it is reasonably certain, based on all relevant factors, that the lessor will **not** exercise the option*

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GASB — Lease Term (Continued)

- Periods for which the lessee and lessor both have the option to terminate the lease without permission from the other party (or if both parties have to agree to extend) are cancelable periods, and excluded for lease term
 - Rolling month-to-month leases
 - Holdover periods until a new lease contract is signed

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FASB — Lease Term

- The lease term is the sum of the following:
 - Non-cancellable period of the lease
 - Any periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise the option
 - Any options to extend controlled by the lessor

GASB — Fiscal Funding or Cancellation Clause

- Fiscal funding or cancellation clause allows governmental lessees to cancel a lease, typically on an annual basis, if the government does not appropriate funds for the lease payments
- This clause does not affect the lease term unless it is reasonably certain the clause will be exercised.

GASB — Contracts that Transfer Ownership

- Contracts that transfer ownership of underlying asset by end of the contract and do not contain termination clause – should be reported as a financed purchase of the underlying asset
- Fiscal funding or cancellation clause that is not reasonably certain of being exercised would be ignored

GASB and FASB — Reasonably Certain

- A judgement made based on the relevant factors

GASB — Relevant Factors

- Factors can be contract based, underlying asset based, market based, or government specific
- Examples include:
 - Significant economic incentive, such as contract terms and conditions for the optional periods that are favorable compared with current market rates
 - Significant economic disincentive, such as costs to terminate and sign a new lease
 - History of exercising options
 - Extent to which the underlying asset is essential to the provision of government services

GASB — Lease Liability

- Present value of payments expected to be made during the lease
- Includes the following:
 - Fixed payments
 - Variable payments that depend on an index rate (CPI or market interest rate) initially measured using the index or rate at the lease term commencement
 - Variable payments that are fixed in substance
 - Amounts reasonably certain to be paid under residual value agreements
 - Exercise price of a purchase option if it is reasonably certain the lessee will exercise the option
 - Termination penalty payments – if the lease term reflects the lessee exercising an option to terminate
 - Lease incentives received from the lessor
 - Any other payments reasonably certain of being required

GASB — Variable Payments

- Variable payments based on future performance of lessee or usage of the underlying asset are NOT included in the measurement of the lease liability
- These variable payments are recognized as expense in the period incurred
- If the variable payment is fixed in substance, it would be part of lease liability measurement



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FASB — Payments

- Include payments made during the lease term
- Optional payments to purchase the underlying asset should be included if the lessee is reasonably certain to exercise that option



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FASB — Variable Lease Payments based on Index or Rate

- Examples – CPI or a market interest rate
- Measured using index or rate at the commencement date
- Not updated unless a re-measurement event takes place

FASB — Other Variable Lease Payment

- Variable lease payments are recognized when achievement of the specified target becomes probable
- Residual value guarantees are included in lease payments when they are considered probable of being owed

GASB — Interest Rate

- Rate implicit in the lease
- If not implicit, lessee's estimated incremental borrowing rate

FASB — Discount Rate

- Rate implicit in the lease contract
- If not determinable, the entity should use its incremental borrowing rate

GASB — Lease Asset

- Sum of the following:
 - Amount of the initial measurement of the lease liability
 - Lease payment made to, or lease incentive received from, the lessor prior to commencement of the lease term
 - Initial direct costs that are ancillary charges necessary to place the lease asset into service



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GASB — Lease Asset (Continued)

- Initial direct costs considered debt issuance costs would be an expense in the period
- Lease asset amortized over shorter of lease term or useful life
- Amortization expense may be reported with depreciation expense
- If a purchase option determined to be reasonably certain to be exercised; amortize over useful life
- Lease asset would be adjusted by same amount as lease liability when re-measured

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GASB — Lease Term Reassessment

- Reassess only if:
 - Option exercised that was previously determined to be reasonably certain not to be exercised
 - Option not exercised that was previously determined to be reasonably certain to be exercised
 - An event specified in the lease contract that requires an extension or termination of the lease takes place



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GASB — Lease Re-measurement

- Lessee should re-measure the lease liability if one or more of the following changes have occurred:
 - Lease term change
 - Residual value guarantee being paid has changed from reasonably certain to not reasonably certain (or vice versa)
 - Purchase option to be exercised has changed from reasonably certain to not reasonably certain (or vice versa)
 - Change in estimated amounts already included in the measurement
 - Change in the interest rate the lessor charges the lessee if used as the initial discount rate
 - A contingency upon which some or all of the variable payments to be paid over the remainder of the lease are resolved so that they now meet the criteria to be included in the measurement

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GASB — Lease Re-measurement (Continued)

- If lease is re-measured; lease liability should also be adjusted for any change in index or rate used
- No re-measurement should be made solely for a change in the index rate (or for a change in the lessee's incremental borrowing rate)

FASB — Lease Re-measurement

- Re-measurement should occur if any of the following occur:
 - Lease is modified and not accounted for as a separate contract
 - Contingency resolved so that some or all variable payments become fixed payments
 - Change in assessment of lease term
 - Change in assessment of whether the lessee is reasonably certain to exercise or not exercise a purchase option
 - Change in amount probable of being owed by lessee under residual value guarantees

FASB — Lease Re-measurement (Continued)

- Reassess the lease term or a lessee option to purchase the underlying asset only if and at the point in time any of the following occur:
 - There is a significant event or a significant change in circumstances within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset
 - There is an event written into the contract that obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease
 - The lessee elects to exercise an option even though the entity had previously determined the lessee was not reasonably certain to do so
 - The lessee elects to not exercise an option even though the entity had previously determined the lessee was reasonably certain to do so

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FASB — Lease Re-measurement (Continued)

- Lease classification and discount rate are re-measured for:
 - Lease is modified and not accounted for as a separate contract
 - Triggering event takes place, which causes the lease term or purchase option to be reassessed

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GASB/FASB — Modification is a Separate Contract

- Account for the modification as a separate contract when both of the following conditions are present:
 - Modification grants the lessee an additional right-of-use not included in the original lease
 - Lease payments increase commensurate with the standalone price for the additional right-of-use



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FASB — Lease Modifications

- “Re-measurement event”
- A change to the terms and conditions of a contract that results in a change in scope of, or the consideration for, the lease
- Examples include a change in the underlying assets, or changes that shorten or lengthen the lease term



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FASB — Modification is Not a Separate Contract

- Reassess lease classification (finance or operating) as of the effective date of the modification based on the modified terms and conditions
- Re-measure variable lease payments based on the index at the re-measurement date and update the discount rate



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FASB — Modification Requires Re-measurement

- Grants the lessee an additional right-of-use not included in the original contract
- Extends or reduces the terms of an existing lease other than through the exercise of a contractual option to extend or terminate the lease
- Changes in consideration in the contract only
- Fully or partially terminates an existing lease

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GASB — Short-term Leases

- Maximum possible term of 12 months or less, including any options to extend regardless of their probability to be extended.
- For leases cancelable by either the lessee or lessor such as rolling month-to-month or year-to-year, the maximum possible term is the noncancelable period, including any notice periods
- Expense or income based on payment provisions (not on straight-line basis)

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FASB — Short-term Leases

- Accounting policy election to not recognize lease assets and lease liabilities with a term of 12 months or less
- Lease expense is generally recognized on a straight-line basis
- Election needs to be consistently applied for similar leases

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Implementation Strategies

- First effective date is year ending December 31, 2020
- Comparative financial statements will require restatement in 2019
- Need to be ready to account for leases under new standard by January 1, 2020
- Waiting for 2020 audit will result in material adjustments
- Waiting for 2019 audit will result in 2020 internal financial statements not reflecting the changes until yearend (or late in year)



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Implementation Strategies (Continued)

- Start right away (at least after 2018 audit, to be ready to implement on January 1, 2020)
- Develop a system/process for monitoring leases
 - Spreadsheet
 - Software
- Update lease inventory
 - Review rent expense, equipment rental, and similar accounts
 - Review/inquiry about contracts with an implicit lease
- Opportunity to review lease procurement procedures



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Implementation Strategies (Continued)

- Capital leases – same as before
- Operating leases – need to analyze every lease
 - Some will be short-term
 - Some may be immaterial
- Contracts with lease and non-lease components – almost certainly not currently accounted for correctly

Materiality Judgements

- Information is material if omitting it or misstating it would influence decisions users make on the basis of financial information about a specific reporting entity
- Quantitative and qualitative judgement
- Individual leases and leases in the aggregate

Materiality Judgements (Continued)

- Practical matter – will need to establish a dollar threshold
- Practical matter – one “standard” does not fit all entities
 - Bond covenants limiting additional debt?
 - Poor financial condition?
 - May impact creditor determination on future lending?



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Effective Dates – Again!

- Fiscal years beginning after December 15, 2019 (except for a few after December 15, 2018)
 - December 31, 2020
 - June 30, 2021
 - September 30, 2021
- Restatements (**need to prepare in 2018**)
 - December 31, 2019
 - June 30, 2020
 - September 30, 2020



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Questions

- Questions?
- Concerns?
- Thoughts?
- Hopes?
- Dreams?



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Bonus Slides

- Lessor accounting
- Related party leases
- Subleases
- Component units
- Disclosures

GASB — Lessor Accounting Overview

- Recognize lease receivable and deferred inflow of resources at lease commencement
- Lease receivable – net present value of expected payment (the same as lease liability)
- Re-measurement of lease receivable (same as lease liability)
- Deferred inflow of resources – amortized over life of lease (generally will equal lease receivable)
- Underlying asset – do derecognize the asset
 - Continue to depreciate and apply impairment guidance
 - Do not depreciate if lessee will return asset in original or enhanced condition
- Disclosures (same as lessee)

FASB — Lessor Accounting Overview

- No significant changes
 - Clarification and consistency of terms
 - Alignment with revenue recognition standards
- Finance
 - Balance sheet – net investment in the lease presented separately
 - Income statement – interest income and any selling profit on the lease
 - Cash flow statement – operating activity
- Operating
 - Balance sheet – continue to recognize underlying asset
 - Income statement – lease income
 - Cash flow statement – operating activity

FASB — Lessor

- Sales-type leases
- Direct financing leases
- Operating leases

FASB — Sales and Leaseback

- Substantial changes
- More real estate may qualify for sale and leaseback accounting
- Lease equipment may qualify for sale and leaseback accounting

GASB — Related Parties

- Same as for similar leases between unrelated parties
- If lease terms significantly affected by the relationship – the accounting should be based on substance.

FASB — Related Parties

- Recognition and measurement based on legally enforceable terms and conditions of the arrangement

GASB — Various

- Subleases – separate transactions; no offsetting
- Sales-Leaseback transactions
 - A sale of an underlying asset by an owner and lease of the property back to the seller (original owner)
 - Two separate transactions
- Lease-Leaseback transactions
 - An asset is leased by one party (first party) to another party, and then leased back to the first party
 - Accounted for as a net transaction

GASB — Intra-Entity Leases between Component Units

- Blended component units
 - Standards do not apply since financial statements are combined
 - Debts and assets of the lessor should be reported as if the debts and assets of the primary government
- Discretely presented component units
 - Standards apply for both lessor and lessee



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GASB — Disclosures

- General description of lease agreement including basis, terms, and conditions on which variable payments are determined *and* the existence, terms, and conditions of residual value guarantees not included in lease liability measurement
- Lease assets and related accumulated amortization (in total and by major class) disclosed separately from other capital assets (face or notes)
- Variable lease payments not included in the lease liability measurement
- Any other payments (residual value guarantees, termination penalties) not included in the lease liability measurement
- Principal and interest requirements to maturity
- Commitments under leases before the commencement of the lease term
- Impairment losses
- Sublease transactions
- Sale-leaseback transactions
- Lease-leaseback transactions



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FASB — Disclosures

- General description of leases
- Basis and terms and conditions on which variable lease payments are determined
- Narrative disclosure about options to extend or terminate
- Residual value guarantees
- Restrictions or covenants imposed by leases

FASB — Disclosures (Continued)

- Subleases
- Lease commitments
- Significant assumptions and judgements
 - Determination of whether a contract contains a lease
 - Allocation between lease and non-lease components
 - Determination of interest rate

FASB — Disclosures (Continued)

- Finance lease cost – amortization and interest components
- Operating lease – cost
- Short-term lease costs
- Variable lease costs
- Sublease income
- Net gain or loss recognized from sale and leaseback transactions

FASB — Disclosures (Continued)

- The following segregated between finance and operating leases:
 - Cash paid
 - Supplemental noncash information
 - Weighted-average remaining lease term
 - Weighted-average discount rate
- Maturity analysis of undiscounted cash flows (aka debt service schedule) with reconciliation to statement of financial position

FASB — Disclosures (Continued)

- Related party leases
- Accounting policy for short-term leases
- Accounting policy if electing to not separate lease and non-lease components