ASSOCIATION OF
Washington Public Hospital Districts

GASB 87: Leases

Hosted By:
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Presented By

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Overview

- Establishes a single approach to accounting for leases, eliminating the current operating and capital lease classifications
  - Operating leases are currently “off-balance sheet” liabilities
- Establishes a single model for lease accounting, based on the foundational principle that leases are financings of the right to use an underlying asset
  - Lessee is required to recognize a lease liability and an intangible right-to-use lease asset
  - Lessors is required to recognize a lease receivable and a deferred inflow of resources

Big Picture

- Public hospital districts (PHDs) will recognize lease assets and lease liabilities on the balance sheet for all leases (except short-term and immaterial leases)
- Balance sheet will change
  - More assets
  - More debt
- Net income will not change significantly
  - Classification changes among lease, depreciation, and interest expenses

Effective Date

- Effective for year ending December 31, 2020
  - All Washington public hospital districts have calendar year ends
- Restate all prior periods presented, if practicable (or cumulative effect reported as a restatement of beginning net position for earliest year restated)
  - If presenting an Management, Discussion, & Analysis – there are two prior years
- Leases are recognized and measured using the facts and circumstances already existing at the beginning of the year of implementation

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 an 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

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)

Contracts that Transfer Ownership

- Contracts that transfer ownership of underlying asset by the end of the contract and do not contain a termination clause should be reported as a financed purchase of the underlying asset

Separating Lease & Non-Lease Components

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

Separating Lease and Non-Lease Components

- 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

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

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

Lease Term

- 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 cancellable periods, and excluded for lease term
  - Rolling month-to-month leases
  - Holdover periods until a new lease contract is signed

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.
- Any fiscal funding or cancellation clause not reasonably certain of being exercised would be ignored

Reasonably Certain

- A **judgement** made based on the relevant factors
  - Events likely to occur
  - Use information available at the time – a judgement based on what you know today
  - Lease term is an “estimate” – it could change

Relevant Factors

- Factors can be contract based, underlying asset based, market based, or government specific
- Examples include:
  - Significant economic incentive, such as contact 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

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

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 (such as a minimum annual guarantee), it would be part of lease liability measurement
- Variable payment tied to an index or rate (CPI or market interest rate) is included in the measurement of the lease liability

Interest Rate

- Rate implicit in the lease
  - Estimate fair value of underlying asset
  - Estimate guaranteed residual value
- If not implicit, lessee's estimated incremental borrowing rate

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

Lease Asset

- 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

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

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

Lease Re-Measurement

- 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)

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 stand-alone price for the additional right-of-use

Other Accounting Considerations

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

Accounting Implementation Strategies

- Effective date is year ending December 31, 2020
- Comparative financial statements will require restatement of 2019
- Need to be ready to account for leases under the 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 year end (or late in year)

Accounting Implementation Strategies

- 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

Accounting Implementation Strategies

- Significant additional resources will be needed to implement the lease standard
  - Most likely can not be absorbed into existing personnel's existing duties
- Identify project leader and availability of resources within your organization to manage the transition process
- Evaluate whether controls and processes are properly designed and implemented across all functional areas (IT, legal, procurement, AP, treasury, accounting)

Accounting Implementation Strategies

- 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
- Immaterial leases

Materiality Judgements

- Information is material if omitting or misstating it would influence the 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

- 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?

Management Considerations

- Property and equipment buy vs. lease decisions
- Budgeting considerations
- Capital budgets
- Medical office building leases
- Vendor negotiations (and renegotiations)
- Lease procurement procedures
- Bond covenants
- Financial ratios

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)

Questions?

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