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# **GASB 87 – The New Lease Standard for Governmental Entities that will Impact Governmental Hospitals**

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Presented by:

Matt Stuart

Principal - Audit & Assurance Services | PYA, P.C.

Presented by:

Shelby Ooten

Audit Senior | PYA, P.C.

Education Partners  
for Florida Hospitals





## Matt Stuart

(800) 270-9629  
[mstuart@pyapc.com](mailto:mstuart@pyapc.com)

PYA, P.C.  
2220 Sutherland Avenue  
Knoxville, TN 37912

Matt is a leader within the Firm's audit service line, where he conducts financial statement audits for a number of organizations, including hospitals and other healthcare providers, foundations, community banks, and not-for-profit organizations. He is experienced in performing employee benefit plan audits as well. He also assists clients with the design and implementation of new internal control policies and procedures.

Matt is a thought leader who often contributes content for Firm-related publications. Additionally, he is a frequent presenter on audit and accounting updates. Matt is a business administration graduate of Appalachian State University, and he earned a Master of Accountancy at the University of Tennessee. He is a Certified Public Accountant licensed in both Georgia and Tennessee and a Fellow of the American College of Healthcare Executives.



## Shelby Ooten

(800) 270-9629

[sooten@pyapc.com](mailto:sooten@pyapc.com)

PYA, P.C.  
2220 Sutherland Avenue  
Knoxville, TN 37912

Shelby performs external financial statement audits, reviews, and compilations as well as internal audit, internal control, and regulatory compliance-related services for financial institutions, health care organizations, captive insurance companies, non-profits, and other commercial entities. Shelby earned a Bachelor of Science in Business Administration and a Master of Accountancy degree from the University of Tennessee and is a Certified Public Accountant.

## Objectives

- Define the financial reporting changes resulting from Governmental Accounting Standards Board (GASB) Statement No 87: Leases
- Review the impact of GASB's one lease model on debt covenants
- Define the difference between new lease rules under the Financial Accounting Standards Board (FASB) and GASB

# Prior to GASB 87

## Operating Leases

- A lease that **does not** transfer substantially all benefits and risks associated with ownership of the property
- Not recorded on the statement of net position
- Lease payments are expensed as incurred to lease expense

## Capital Leases

- A lease that **does** transfer substantially all benefits and risks associated with ownership of the property
- Must meet one of four lease classification criteria
- Results in a lease asset and a lease liability on the statement of net position
- Lease asset is amortized/depreciated over the lease term and the lease liability is removed as payments are made with a portion of the payments being recorded as interest expense

# Prior to GASB 87

## Capital Lease Criteria

1. The lease transfers ownership of the property to the lessee by the end of the lease term, or
2. The lease contains a bargain purchase option, or
3. The lease term is equal to 75% or more of the estimated economic life of the leased property, or
4. The present value of minimum lease payments at the beginning of the lease term equals or exceeds 90% of the fair value of the leased property at lease inception

## Polling Question

How prepared would you say your organization is for the transition to GASB 87?

- a. Very Prepared
- b. Somewhat Prepared
- c. Not Prepared
- d. I've never heard of GASB 87

# After GASB 87

## Operating Leases

- A lease that does not transfer substantially all benefits and risks associated with ownership of the property
- Not recorded on the balance sheet
- Lease payments are expensed as incurred to lease expense

## Capital Leases

- A lease that does transfer substantially all benefits and risks associated with ownership of the property
- Must meet lease classification criteria
- Results in a lease asset and a lease liability on the balance sheet
- Lease asset is amortized/depreciated over the lease term and the lease liability is removed via interest expense

## After GASB 87

### Single Lease Model: Financing Leases

“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.”

Leases now include contracts that might not be explicitly identified as leases but meet the above definition of a lease.

## After GASB 87

A contract conveys control of the right to use the underlying asset if the government has:

1. The right to obtain the present service capacity from use of the underlying asset as specified in the contract
- AND**
2. The right to determine the nature and manner of use of the underlying asset as specified in the contract.

# Financing Leases

## Lessee Accounting

Commencement

- At lease commencement, the lessee will recognize a lease liability and an intangible right-to-use asset
- The lease liability is measured at the present value of payments expected to be made during the lease term
- The lease asset is measured at the amount of the initial lease liability plus any payments made to the lessor at commencement of the lease term and direct costs.

First Year

- The lease liability is reduced as payments are made
- The lease asset is amortized over the shorter of the lease term or the useful life of the asset

# Financing Lease Example

## Facts:

- 10-year lease
- Lease payment = \$1,000,000/year
- Initial direct costs = \$500,000
- Discount rate = 2.5%
- Present value of remaining lease payments after payment of 1st year rental and initial direct costs = \$7,970,866

# Financing Lease Example

## At Commencement:

Right-of-use asset	9,470,866
Lease liability	7,970,866
Cash (lease payment for year 1)	1,000,000
Cash (initial direct costs)	500,000

## After First Year:

Interest expense	199,272 <sup>(1)</sup>
Lease liability	199,272
Amortization expense	947,087 <sup>(2)</sup>
Right-of-use asset	947,087

(1) Calculated as  $(2.5\% \times 7,970,866)$

(2) Calculated as  $(9,470,866 \div 10)$

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# Lessee Disclosures

A lessee should disclose the following about its lease activities:

1. A general description of the lease
2. The total amount of lease assets, and related accumulated amortization
3. The amount of lease assets by major classes of underlying assets
4. The amount of outflows of resources recognized in the reporting period for other payments related to the lease not previously included in the lease liability
5. Principal and interest requirements to maturity for the lease liability for each of the five subsequent fiscal years and in five-year increments thereafter
6. Commitments under leases before the commencement of the lease term
7. The components of any loss associated with impairment recognized on the lease asset during the period

*Leases may be grouped together but must be reported separately from other capital assets*

# Financing Leases

## Lessor Accounting

- At lease commencement, the lessor will recognize a lease receivable and deferred revenue
- The lessor will not derecognize the asset underlying the lease and will continue to recognize depreciation or impairment as applicable
- The lease receivable is measured at the present value of payments expected to be made during the lease term
- The deferred revenue is measured at the amount of the lease receivable plus any payments received before commencement of the lease term that relate to future periods
- The lessor recognizes interest revenue on the lease receivable and revenue from the deferred revenue over the term of the lease

# Financing Lease ~ Determination of the Lease Term

The lease term is defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable

- Periods covered by a lessee's or lessor's option to extend the lease if it is *reasonably certain*, based on all relevant factors, that the lessee or lessor will exercise their respective option.
- Periods covered by a lessee's or lessor's option to terminate the lease if it is *reasonably certain*, based on all relevant factors, that the lessee or lessor will not exercise their respective option.

## After GASB 87

Exceptions exist for “short term leases”

A short-term lease is defined as a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised.

For short term leases, no asset or liability is recognized, and lease payments are expensed as incurred.

## After GASB 87

Contracts that **transfer ownership** of the underlying asset to the lessee by the end of the contract and **do not contain termination options** should be reported as a **financed purchase** of the underlying asset by the lessee or **sale of the asset** by the lessor.

## Polling Question

How does the new single lease model impact EBIDTA?

- a. It decreases interest expense, resulting in decreased EBITDA
- b. It increases interest expense, resulting in decreased EBITDA
- c. It increases interest expense, resulting in increased EBITDA
- d. It decreases interest expense, resulting in increased in EBITDA

## Impact on Debt Covenants

**ALL** leases (except short term) are now reported on the statement of net position.

Contracts not previously recognized as leases, or leases previously accounted for as operating leases, now result in:

1. An increase in liabilities as the lease liability is now reported on the statement of net position
2. An increase in earnings before interest, taxes, depreciation, and amortization (EBITDA) as “lease expense” is replaced with interest and amortization expense.

# Key Differences

## GASB 87

- One lease model, *Financing*
- All leases result in a lease asset and lease liability
- All leases result in interest and amortization expense

## FASB ASC 842

- Leases are either *operating* or *financing*
- All leases result in a lease asset and lease liability
- *Operating* leases result in lease expense, while *financing* leases result in interest and amortization expense

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# FASB ASC 842

## Finance Lease Criteria:

1. Transfer of ownership of underlying asset to lessee by end of lease term
2. Lease grants lessee the option to purchase the underlying asset that lessee is reasonably certain to exercise
3. Lease term is for a major part of the remaining economic life of the underlying asset
4. PV of the sum of lease payments and any residual value guaranteed by lessee  $\geq$  substantially all of the FV of underlying asset
5. Underlying asset is of such a specialized nature that it is expected to have no alternative use to lessor at end of lease term

***If one or more of the above are met, classify as a finance lease.  
Otherwise, classify as an operating lease under ASC 842.***

## Polling Question

Under the new GASB 87, what situation would preclude a lease from being recorded on the statement of net position?

- a. The present value of total lease payments is immaterial to the lessee
- b. A lease term of six months, with no options to extend
- c. A lease term of six months, with an option to extend for an additional seven months
- d. A lease that does not transfer substantially all benefits and risks associated with ownership of the property

## Implementation of GASB 87

GASB 87 will apply to **all contracts** existing as of the implementation date and must be **applied retrospectively** to all periods presented in the year of adoption, if practical.

Note: For existing capital leases, lessees will not need to restate the underlying asset associated with those leases.

The process of accumulating data, reviewing existing agreements, and evaluating the adequacy of existing accounting systems in preparation for the implementation of GASB 87 can be very time consuming. Start now!

# GASB 87 Effective Date

Reporting periods beginning after December 15, 2019.  
Early adoption encouraged.



Questions?

# Thank You!

Matt Stuart  
(800) 270-9629  
[mstuart@pyapc.com](mailto:mstuart@pyapc.com)

Shelby Ooten  
(800) 270-9629  
[sooten@pyapc.com](mailto:sooten@pyapc.com)

[pyapc.com](http://pyapc.com)

