GASB No. 87 - Lessor Example

A City leases a portion of their municipal building space to a local coffee shop (lessee). The lease commences on January 1, 2021 with monthly payments of 10% of revenue with a minimum payment of $2,500 due on the last day of each month. The initial lease term is 36 months with two renewal options for 12 months each. The City maintains ownership of the building space throughout the contract and following the end of the lease term. The remaining useful life of the building is 180 months. The City's carrying value of the building space is $150,000. The City is reasonably certain that the tenant will exercise both renewal options.

Step 1: Determine the type of lease you have.

Per GASB Statement No. 87 (GASB No. 87), a short-term lease will have a maximum possible term of 12 months. That includes any extension options even if it is reasonably certain the extensions will not be exercised.

The maximum possible term of the City's contract is 60 months, the initial lease term of 36 months plus the two options to renew for another 12 months each; therefore, it is not a short-term Lease.

Per GASB No. 87, to be treated as a contract that transfers ownership, the contract has to transfer ownership of the underlying asset to the lessee by the end of the contract and it cannot contain termination options regardless of their likelihood of being exercised. The contract can contain a fiscal funding or cancellation clause that is reasonably certain *not* to be exercised.

The City's contract does not transfer ownership by the end of the contract; therefore, it is not treated as a contract that transfers ownership and thus is not a financed purchase.

Since the City's contract is not a short-term lease and is not a financed purchase (automatic transfer of ownership, it is treated as a lease under GASB No. 87 and requires calculation of a lease receivable and a deferred inflow of resources.

Step 2: Identify the lease term.

The lease term consists of the period during which the lessee has a noncancelable right to use the underlying asset plus (a) any periods in which the lessee *or* the lessor have the option to extend and are reasonably certain to exercise the option and (b) any periods in which the lessee *or* the lessor have the option to terminate and are reasonably certain *not* to exercise the option. If the lessee and the lessor have the option to terminate without permission from the other party, or both parties have to agree to extend, those periods are excluded from the lease term.

The City's contract with the lessee is for an initial period of 36 months. The lessee can renew for two additional 12-month periods after the initial 36 months and the City is reasonably certain the lessee will exercise those options. The City's total lease term for calculating the lease receivable and deferred inflow of resources would be 60 months. The initial 36 months plus the 24 months for the renewal options that the City is reasonably certain the lessee will exercise.

Step 3: Identify the payments that will be included in the lease receivable calculation.

The City's contract mentions a monthly payment of 10% of revenue with a minimum payment of $2,500. The $2,500 would be considered a variable payment fixed in substance because the lessee is guaranteed to be required to pay the $2,500 regardless of their revenue for the month. Variable payments fixed in substance are included in the lease receivable calculation per GASB NO. 87. The 10% of revenue above the $2,500 cannot be predicted (variable payments based on future performance) as of the beginning of the lease period and would be excluded from the lease receivable calculation.

Step 4: Calculate your lease receivable and deferred inflow of resources.

The lease receivable calculation is the present value of the payments expected to be received during the lease term, which we detailed in Step 3. The deferred inflow of resources calculation is the lease receivable plus any initial direct costs and any lease payments received at or before the commencement of the lease term less any lease incentives paid to the lessee at or before the commencement of the lease term.

The lease payments expected to be received are discounted at the interest rate the City charges the lessee which is assumed to be 4.75% for this example.

The present value of the lease receipts identified in Step 3 using a discount rate of 4.75% is $133,284.20. This is the beginning balance of the lease receivable, and since there are no initial direct costs, prepayments or incentives identified, this is also the beginning balance of the deferred inflow of resources.

The lease receivable is reduced by the difference between the monthly payment received and the calculated interest income for that period. The deferred inflow of resources is reduced by the straight-line amortization over the lease term.

The City has to continue to depreciate the underlying asset using the carrying value of the asset as of the commencement date.

Below are the first several periods of the lease receivable schedule, deferred inflow of resources schedule, underlying asset schedule and the starting journal entries for this example.

	LEASE RECEIVABLE					DEFERRED INFLOW OF RESOURCES				UNDERLYING ASSET SCHEDULE		
Date	Beginning Balance	Lease Receipt	Interest Income	Ending Balance		Beginning Balance	Lease Revenue	Ending Balance		Beginning Balance	Depreciation Expense	Ending Balance
1/31/21	$ 133,284.20	$ 2,500.00	$ 527.58	$ 131,311.78		$ 133,284.20	$ 2,221.40	$ 131,062.80		$ 150,000.00	$ 833.33	$ 149,166.67
2/28/21	$ 131,311.78	$ 2,500.00	$ 519.78	$ 129,331.56		$ 131,062.80	$ 2,221.40	$ 128,841.39		$ 149,166.67	$ 833.33	$ 148,333.33
3/31/21	$ 129,331.56	$ 2,500.00	$ 511.94	$ 127,343.50		$ 128,841.39	$ 2,221.40	$ 126,619.99		$ 148,333.33	$ 833.33	$ 147,500.00
4/30/21	$ 127,343.50	$ 2,500.00	$ 504.07	$ 125,347.56		$ 126,619.99	$ 2,221.40	$ 124,398.59		$ 147,500.00	$ 833.33	$ 146,666.67
5/31/21	$ 125,347.56	$ 2,500.00	$ 496.17	$ 123,343.73		$ 124,398.59	$ 2,221.40	$ 122,177.18		$ 146,666.67	$ 833.33	$ 145,833.33
6/30/21	$ 123,343.73	$ 2,500.00	$ 488.24	$ 121,331.97		$ 122,177.18	$ 2,221.40	$ 119,955.78		$ 145,833.33	$ 833.33	$ 145,000.00

FULL ACCRUAL JOURNAL ENTRIES

1/1/21	Lease Receivable	$ 133,284.20	
	Deferred Inflow of Resources		$ 133,284.20
	To record initial lease receivable and deferred inflow of resources.		
1/31/21	Deferred Inflow of Resources	$ 2,221.40	
	Lease Revenue		$ 2,221.40
	To record first period of lease income.		
1/31/21	Cash	$ 2,500.00	
	Interest Income		$ 527.58
	Lease Receivable		$ 1,972.42
	To record the first receipt of lease payment.		
1/31/21	Depreciation Expense	$ 833.33	
	Accumulated Depreciation		$ 833.33
	To record first period of depreciation expense.		

MODIFIED ACCRUAL JOURNAL ENTRIES

1/1/21	Lease Receivable	$ 133,284.20	
	Deferred Inflow of Resources		$ 133,284.20
	To record initial lease receivable and deferred inflow of resources.		
1/31/21	Deferred Inflow of Resources	$ 2,221.40	
	Lease Revenue		$ 2,221.40
	To record first period of lease income.		
1/31/21	Cash	$ 2,500.00	
	Interest Income		$ 527.58
	Lease Receivable		$ 1,972.42
	To record the first receipt of lease payment.		