GASB No. 87 - Lessee Example

A County enters into a lease for a copier on January 1, 2021 with monthly payments due on the last day of each month of $225 per month and 5 cents per copy for all copies over 1,000. The initial lease term is 12 months with an option to renew for an additional 12 months. The County has the option to terminate the lease after the first six months. After the initial lease term and renewal period, the County has the option to purchase the copier for $600 to be included in their final lease payment. The lessor maintains ownership of the copier unless the County exercises their purchase option, at which time the title to the copier will be provided to the County. The remaining useful life of the copier is 36 months. The County is reasonably certain that they will exercise their renewal option and the purchase option at the end of the renewal period. The County will incur $150 of costs to put the copier into service.

Step 1: Determine the type of lease you have.

Per GASB Statement 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 County's contract is 24 months, the initial lease term of 12 months and the option to renew of another 12 months; 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 County's contract does not transfer ownership, but rather offers a purchase option at the end of the lease term. The contract also offers a termination option; therefore, it is not a contract that transfers ownership and is thus not a financed purchase (debt).

Since the County's contract is not a short-term lease and is not a financed purchase (automatic transfers of ownership), it is treated as a lease under GASB No. 87 and requires calculation of a lease asset and a lease liability.

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 County's contract is for an initial period of 12 months. The County can cancel after 6 months, but they are reasonably certain they will not exercise that option. The County can renew for an additional 12 months after the initial 12 months and they are reasonably certain they will exercise that option. The County's total lease term would be 24 months. The initial 12 months plus the 12 months for the renewal option that the County is reasonably certain they will exercise.

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

The County's contract mentions a monthly payment of $225 and 5 cents per copy for all copies over 1,000. The County also incurs $150 worth of costs to place the copier into service. The purchase option price for the copier is $600.

The $225 would be considered a fixed payment and would be included in the lease liability calculation per GASB No. 87. The 5 cents per copy for all copies over 1,000 is based on usage of the underlying asset (variable payments based on future performance), which GASB No. 87 states should be excluded from the lease liability calculation. The County is reasonably certain they will exercise the purchase option for $600 as of the last payment period of the lease. Based on this information, the County would include the $225 per month for the first 23 months and $825 (monthly payment of $225 plus the $600 purchase option price) for the 24th month in the lease lability calculation. After calculating the lease liability, the County would include the initial direct costs of $150 in their lease asset beginning balance.

Step 4: Calculate your lease liability and lease asset.

The lease liability calculation is the present value of the payments expected to be made during the lease term, which we detailed in Step 3. The lease asset calculation is the lease liability plus any initial direct costs and any lease payments made at or before the commencement of the lease term less any lease incentives received at or before the commencement of the lease term.

There was no stated interest rate included in the contract details, nor were there details indicating the implicit interest rate in the lease. The County will have to use their incremental borrowing rate, which is the rate they would be charged for borrowing the lease payment amounts during the lease term. For this example, we will assume an incremental borrowing rate of 2.25%.

The present value of the lease payments identified in Step 3 using a discount rate of 2.25% is $5,849.09. This is the beginning balance of the lease liability. The lease liability plus the initial direct costs of $150 is the beginning balance of the lease asset or $5,999.09.

The lease liability is reduced by the difference between the monthly payment and the calculated interest for that period. The asset is reduced by the straight-line amortization over the shorter of the lease term or the useful life of the asset. Per GASB No. 87, if the lessee is reasonably certain to exercise a purchase option, the lease asset should be amortized over the useful life of the underlying asset. The County is reasonably certain they will exercise their purchase option; therefore, their lease asset will be amortized over 36 months (remaining useful life).

Below is the beginning of the lease liability schedule, lease asset schedule and starting journal entries for this example.

	LEASE LIABILITY				LEASE ASSET		
Date	Beginning Balance	Lease Payment	Interest Expense	Ending Balance	Beginning Balance	Amortization Expense	Ending Balance
1/31/21	$ 5,849.09	$ 225.00	$ 10.97	$ 5,635.06	$ 5,999.09	$ 166.64	$ 5,832.45
2/28/21	$ 5,635.06	$ 225.00	$ 10.57	$ 5,420.62	$ 5,832.45	$ 166.64	$ 5,665.81
3/31/21	$ 5,420.62	$ 225.00	$ 10.16	$ 5,205.79	$ 5,665.81	$ 166.64	$ 5,499.17
4/30/21	$ 5,205.79	$ 225.00	$ 9.76	$ 4,990.55	$ 5,499.17	$ 166.64	$ 5,332.52
5/31/21	$ 4,990.55	$ 225.00	$ 9.36	$ 4,774.90	$ 5,332.52	$ 166.64	$ 5,165.88
6/30/21	$ 4,774.90	$ 225.00	$ 8.95	$ 4,558.86	$ 5,165.88	$ 166.64	$ 4,999.24
7/31/21	$ 4,558.86	$ 225.00	$ 8.55	$ 4,342.41	$ 4,999.24	$ 166.64	$ 4,832.60
8/31/21	$ 4,342.41	$ 225.00	$ 8.14	$ 4,125.55	$ 4,832.60	$ 166.64	$ 4,665.96
9/30/21	$ 4,125.55	$ 225.00	$ 7.74	$ 3,908.28	$ 4,665.96	$ 166.64	$ 4,499.32
10/31/21	$ 3,908.28	$ 225.00	$ 7.33	$ 3,690.61	$ 4,499.32	$ 166.64	$ 4,332.68

FULL ACCRUAL JOURNAL ENTRIES			
1/1/21	Right-of-Use Asset	$ 5,999.09	
	Lease Liability		$ 5,849.09
	Cash (Initial Direct Costs)		$ 150.00
	To record initial right-of-use asset and lease liability.		
1/31/21	Amortization Expense	$ 166.64	
	Accumulated Amortization		$ 166.64
	To record the first month of amortization expense of the right-of-use asset.		
1/31/21	Lease Liability	$ 214.03	
	Interest Expense	$ 10.97	
	Cash		$ 225.00
	To record the first payment on the lease liability.		

MODIFIED ACCRUAL JOURNAL ENTRIES			
1/1/21	Expenditure: Right-of-Use Asset	$ 5,999.09	
	Other Financing Source: Lease		$ 5,849.09
	Cash (Initial Direct Costs)		$ 150.00
	To record initial right-of-use asset and lease liability.		
1/31/21	Expenditure: Lease Principal	$ 214.03	
	Expenditure: Lease Interest	$ 10.97	
	Cash		$ 225.00
	To record the first payment on the lease liability.		