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At a glance

Changes are in store for all governmental entities that have leases

GASB issues new lease accounting rules

What happened?

On June 28, 2017, the GASB issued its long-awaited revision to governmental lease accounting.[1] Lessees and lessors alike will see significant changes.

Key provisions

Lessees

The GASB rules will bring substantially all leases on to lessees' balance sheets. For operating leases (which today are off-balance sheet), lessees will be required to recognize an asset for the right to use the leased item and a corresponding lease liability. This requirement is broadly consistent with leasing standards recently issued by the FASB and IASB[2], which differ significantly in other respects.

The GASB's rules closely follow the IASB's approach, eliminating all distinctions between operating and capital leases and treating all leases as financings (similar to capital lease accounting today). Lease liabilities will be considered long-term debt, and lease payments will be capital financing outflows in the cash flow statement. In the activity statement, lessees will no longer report rent expense for today's operating-type leases, but will instead report interest expense on the liability and amortization expense related to the asset.

Lessors

The GASB developed a unique model for lessors that differs significantly from both the FASB and IASB approaches. Under the GASB's rules, lessor accounting will mirror lessee accounting. Lessors will recognize a lease receivable and a corresponding deferred inflow of resources (with certain exceptions) while continuing to report the asset underlying the lease. Interest income associated with the receivable will be recognized using the effective interest method. Lease revenue will arise from amortizing the deferred inflow of resources in a systematic and rational manner over the lease term. The new rules exclude leases associated with investment assets carried at fair value (e.g., investment rental property), which will continue to be accounted for as they are today.

Why is this important?

Because the GASB's existing lease rules were derived from the FASB's original lease accounting rules (FASB Statement No. 13), GASB entities and FASB entities currently report leases similarly, recognizing a distinction between operating and capital leases.

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[1] GASB Statement No. 87, *Leases*
2 Accounting Standards Codification, *Leases (Topic 842)*; International Financial Reporting Standard No. 16, *Leases*

Once the new standards take effect, FASB and GASB entities will apply different accounting for operating-type leases. This may add complexity when comparing financial statements of entities in sectors comprised of both GASB and FASB reporters, such as higher education and healthcare.

Lenders, investors in municipal bonds, municipal bond analysts, and other financial statement users will need to ensure that they understand the significant differences in the models, and in particular how operating leases are treated. Although assets and liabilities will be measured similarly for GASB and FASB reporters on "day 1," the "day 2" amounts reported for the right-of-use asset and the resulting impacts on the performance and cash flow statements will differ significantly. For example:

- Right-of-use assets may amortize more quickly than the liabilities under the GASB model, negatively impacting net position. Under the FASB model, the asset and liability amounts will generally equal each other throughout the lease term.
- FASB entities will report lease liabilities as long-term "operating" payables. GASB entities will report these liabilities as long-term debt, heightening concerns about compliance with restrictive debt covenants.
- FASB entities will continue to report straight-line rent expense (similar to current rules). GASB entities will report interest expense on the liability and amortization expense related to the asset, thus front-loading the expense recognition.
- In cash flow statements, lease payments will be classified as capital financing outflows by GASB entities and operating outflows by FASB entities.

What's next?

The GASB's new rules are effective for reporting periods beginning after December 15, 2019, with earlier application encouraged.

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