Proposed Changes in Lease Accounting

by Gemma Han

The accounting guidance for leases for tribal governments, as well as Indian gaming operations, is provided in Governmental Accounting Standards Board (GASB) Statement No. 62, "Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements." Under Statement No. 62, there are currently two ways to account for a lease, either as a capital or operating lease.

Capital Leases

A lease is considered a capital lease if it meets one of the following:

- The life of the lease exceeds 75% of the life of the asset.
- There is a transfer of ownership to the lessee at the end of the lease term.
- There is a bargain price purchase option for the lessee at the end of the lease term.
- The present value of the lease payments, discounted at an appropriate discount rate, exceeds 90% of the fair market value of the asset.

A capital lease is treated as a financed purchase of the asset because substantially all of the risks and benefits associated with ownership of the underlying asset are transferred to the lessee. As such, it is recorded on the balance sheet or statement of net position of the lessee as both an asset and a capital lease liability.

Operating Leases

Under an operating lease, the lessor transfers only the right to use the property to the lessee, and the asset is generally returned to the lessor at the end of the lease term. Therefore, operating leases are often considered "off balance sheet financing" because the associated asset and related obligation are not recorded, but rather all payments made are recognized on the statement of revenues, expenses, and changes in net position. Operating leases essentially realize the expense of the lease at the time lease payments are incurred as lease expense rather than as amortization and interest expense over the related terms/useful lives.

Changes on the Horizon

On January 25, 2016, GASB issued an exposure draft regarding leases. The proposed statement establishes a single model for lease accounting and financial reporting for leases, thereby eliminating the classification distinctions between capital and operating leases. Under the proposed statement, a lessee will be required to recognize a lease liability and an intangible right-to-use lease asset for all leases with the exception of short-term leases. Therefore, the proposed statement will require reporting of certain lease assets and liabilities that are not reported under current generally accepted accounting principles (GAAP). This change could also impact those properties that are required to comply with debt covenants or statutory debt limits as capital and operating leases (under current GAAP) are often treated differently for calculating those covenants or limits.

A careful review of the proposed changes to lease accounting is highly advised as those changes could significantly impact financial reporting for your property. Identified below are direct excerpts from the proposed statement which are intended to illustrate the key aspects of the changes:

Scope and Applicability - The proposed statement applies to financial statements of all state and local governments (and Indian tribal governments) except for the following:

a. Lease contracts for intangible assets (including lease contracts concerning the rights to explore for or to exploit natural resources such as oil, gas, and similar nonregenerative resources).

b. Leases of biological assets, including timber.

c. Contracts that meet the definition of a service concession arrangement.

d. Leases in which the underlying asset is financed with outstanding conduit debt, unless both the underlying asset and the conduit debt are reported by the lessor.

Definition - A lease is defined as a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction. Leases include contracts that, although not explicitly identified as leases, meet the definition of a lease. This definition excludes contracts for services except those contracts that contain both a lease component and a service component.

Lease Term - The lease term is the period during which a lessee has a noncancelable right to use an underlying asset plus the following periods, if applicable, covered by a lessee's option to:

a. Extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option.

b. Terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option.

Periods for which both the lessee and the lessor have an option to terminate the lease, or for which only the lessor has that option, are cancelable periods and are excluded from the lease term.

Recognition and Measurement for Lessees - Under the proposed statement, a lessee should recognize a lease liability and a lease asset for all leases, except for short-term leases. A lease contract that transfers ownership of the underlying asset to the lessee at or before the end of the lease and does not contain termination options should be reported as a financed purchase of that asset, which is considered a capital lease under current GAAP.

Short-Term Leases - A short-term lease is a lease that, at the beginning of the lease, has a maximum possible term under the contract of 12 months or less, including any options to extend, regardless of its probability of being exercised. For a lease that is cancelable by either the lessee or the lessor, such as a month-to-month lease or a year-to-year lease, the maximum possible term is the noncancelable period, including any notice periods.

Lease Liability - A lessee should measure that lease liability initially at the present value of payments expected to be made for the lease term. Measurement of the lease liability should include the following types of payments that might be required by a lease:

a. Fixed payments, less any lease incentives receivable from the lessor.

b. Variable lease payments that depend on an index or a rate.

c. Variable lease payments that are fixed in substance.

d. Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees.

e. The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option.

f. Payments for penalties for terminating the lease, if the lease term reflects that lessee exercising an option to terminate the lease or a fiscal funding or cancellation clause.

g. Any other payments that are reasonably certain of being required based on an assessment of all relevant factors.

The future lease payments should be discounted using the rate the lessor charges the lessee, which may be the interest rate implicit in the lease. If the rate cannot be readily determined by the lessee, the lessee's incremental borrowing rate (the estimated rate that will be charged for borrowing the lease payment amounts for the lease term) should be used.

Lease Asset - A lessee should initially measure the lease asset as the sum of the following:

a. The amount of the initial measurement of the lease liability.

b. Lease payments made to the lessor at or before the beginning of the lease, less any lease incentives received from the lessor.

c. Initial direct costs that are ancillary charges necessary to place the lease asset into service.

Any initial direct costs that would be considered debt issuance costs under GAAP should be recognized as an expense in the period in which they are incurred. The lease asset should be amortized in a systematic and rational manner.

Potential Impacts on Common Agreements

Casinos often have lease agreements with gaming vendors to rent or purchase gaming machines and payments are based on a certain percentage of the net win of leased machines. Under both current GAAP and the proposed statement, variable payments based on future performance of the lessee are not to be included in the computation of a lease asset or liability. However, under the proposed guidance, any component of the required lease payments that is fixed in substance would be included in determining a lease asset and liability. The proposed statement could also impact other leases including, but not limited to, equipment, modular buildings, and intra-entity lease arrangements.

GASB currently has a proposed schedule to review and redeliberate the proposed statement based upon respondent feedback during the fall of 2016 with a goal of issuing a final statement in December of 2016.

In summary, the agreements that your casino operations have entered into may be complex, and there can be many varieties of leases; therefore, it will be critical for management to evaluate implementation of the final statement for current and future financial reporting under GAAP. ♣

Gemma Han is a Partner at BlueBird, CPAs. She can be reached by calling (775) 827-5999 or email ghan@bluebirdcpas.com.