2021 State Treasurer's Auditing, Reporting, and Review

GASB Update

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Exposure Draft

The Comprehensive Annual Financial Report

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Project Highlights

- Proposed statement would rename the current Comprehensive Annual Financial Report (CAFR) to Annual Comprehensive Financial Report (ACFR)
- Pronunciation of current acronym has similarities to terms that are derogatory in certain countries and societies
- Project currently in Exposure Draft stage

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Practical Effects and Reactions

- GASB realized the cost to change publications, online references, etc., but believed the removal of a potentially offensive term outweighs those costs
- GFOA adopted a policy earlier this year encouraging immediate modifications of verbal references to the new terminology

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Implementation Guidelines

- GASB anticipates adopting a final standard in October 2021
- Has encouraged "implementation" before that date and early implementation thereafter
- Effective for fiscal years that begin after 12/15/21 (FYE 6/30/22)

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GASB Statement No. 84

Fiduciary Activities

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GASB Definition of a Pension / OPEB Trust

- Qualified trust has the following characteristics:
  - Contributions to the pension / OPEB plan by employer governments or other entities and earnings are irrevocable
  - Sole purpose of assets in the pension / OPEB plan – provide pensions / OPEB under the benefit terms
  - Assets in pension / OPEB plan protected from creditors of employer governments, administrator, contributors, plan members

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Other Trusts

- - Assets are administered through a trust in which the government itself is not a beneficiary
- - Trust is dedicated to providing benefits to recipients in accordance with the benefit terms
- - Legally protected from government creditors

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Fiduciary Fund Reporting

- Fiduciary fund types for *legally entrusted* arrangements
  - Pension (and other employee benefit) trust funds
    - Pension plans
    - OPEB trust
    - Fiduciary component units (e.g., pensions that meet component unit criteria as per GASB Statement No. 14, *The Financial Reporting Entity*)

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Fiduciary Fund Reporting (cont.)

- Investment trust funds – external investment pools
- Private-purpose trust funds
  - Legally entrusted assets that are *not* pension or OPEB assets
  - Government named as trustee but *not* the beneficiary
  - May be expendable or nonexpendable in nature

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Fiduciary Fund Reporting (cont.)

- Fiduciary fund type for such activities *not legally entrusted*
  - Custodial funds
    - Such funds may have equity

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When are activities other than Pensions/OPEB considered to be fiduciary?

- When the following are all met:
  - The assets are controlled by the government
    - When the government holds the assets, and
    - When the government has the ability to direct the use of the assets
  - The assets are not derived from either
    - Own-source revenues (solely), OR
    - Government-mandated or voluntary nonexchange transactions

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When..? (cont.)

- The assets have one or more of the following characteristics
  - Assets are administered through a trust, dedicated to providing benefits according to specified terms, and legally protected from creditors
  - Assets are for the benefit of individuals and the government does NOT have administrative involvement

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Examples of Non-Pension/OPEB Fiduciary Activities?

- Custodian of cash collected from fees charged by a cemetery association (not a component unit); activity administered through a trust the city maintains
  - Yes, should be reported as fiduciary activity
- City-hired contractor pays a cash deposit for assurance; city takes custody of the deposit
  - No, the cash is for the city's benefit

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Examples (cont.)

- City-hired contractor provides a performance bond instead of cash deposit
  - No, still for the city's benefit
- Retainage held by government during a construction project
  - No, for the government's benefit
- Inmate funds held by a county government
  - Yes, the funds belong to the inmate and the government does not determine how they are used

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Examples (cont.)

- Employee tax withheld, as well as the employer's share
  - No, ultimately an obligation of the government that they cannot avoid

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Fines & Forfeitures / DSS Client Accounts / Deed of Trust

- Currently accounted for in Agency Funds
  - Budget implications
- Should be in Governmental Funds
  - LGC recommendation - Special Revenue Funds
  - Must be budgeted
  - Changes should be made in 20 – 21 FY
  - LGC will probably not enforce for 20 - 21

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Fiduciary Financial Statements

- Statement of Fiduciary Net Position
- Statement of Changes in Fiduciary Net Position
- Prepared on economic resources measurement focus, accrual basis of accounting

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Implementation Date

- Implementation Guide 2019-2, *Fiduciary Activities,* released in June 2019
- Fiscal years that begin *after* ~~12/15/18~~ 12/15/19 (FYE 6/30/21)

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GASB Statement No. 87

Leases

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Scope and Approach

- "A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction."
- All leases are financings of the right to use an underlying asset
- Statement does not apply to leases for intangible assets (computer software), biological assets, service concession arrangements, supply contracts

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Lease Term

- Lessee has noncancelable right to use underlying asset plus various extensions if it is reasonably certain to add to the lease term
- Periods cancelable by either party without the permission of the other party should not be included in the lease term even if there are significant cancellation penalties
- Factors to be considered when evaluating reasonably certainty when reviewing lease term options:
  - Factors may be asset-based, market-based or government specific
  - Economic incentives or disincentives
  - Historical experience
  - Essential nature of asset

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Lease Term (cont.)

- Lease terms are reassessed only if:
  - Option not exercised after initial determination that option was reasonably certain to be exercised
  - Option exercised after initial determination that option was not reasonably certain to be exercised
  - An event in the lease agreement takes place that requires an extension or termination of the lease agreement
  - Reassessment does not take place until option exercised
- ALL lease terms evaluated at implementation of GASB 87 as if new
- Effect of fiscal funding clauses
  - These are called non-appropriation clauses
  - Can be ignored unless it is reasonably certain that they will be exercised

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Contracts That Transfer Ownership

- Title transfers to lessee by end of lease term and does not contain termination clauses
- Conceptually similar to an installment purchase agreement (GS 160A-20)
- Accounted for as a debt-financed purchase
- BPO by itself does not trigger this provision

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Short-Term Leases

- Short-term leases – maximum possible term of one year or less
  - For purposes of determining short-term leases, potential lease term includes options to extend regardless of probability that they will be exercised
  - If period of use is not consecutive, would need to add use periods to determine if it is a short-term lease
  - Periods that are cancelable by both parties are not included, even if there are significant cancellation penalties
  - A series of related one-year agreements for the same property is not a series of short-term leases if they are negotiated as a package with a single objective or the payment of one contract depends on the performance of another contract
  - Accounting is similar to current accounting for operating leases

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Initial Reporting – Liability - Lessee

- Recognize lease liability – this is step 1
  - PV of payments expected to be made in lease term
  - Includes some variable payments that are fixed in substance or that can be calculated at beginning of lease based on a rate or index, but not payments based on volume of usage
  - Variable payments based on a rate or index should be based on the rate or index at the start of the lease term
  - Non-lease components should be accounted for separately
  - Estimates should be used if the exact amount is unknown even for non-lease components
  - Include lease incentives
  - Include purchase options if they are reasonably certain to be exercised
  - Include reasonably certain payments of residual value guarantees
  - Include termination penalties and other payments in certain circumstances

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Initial Reporting – Lease Asset - Lessee

- Recognize lease asset – this is step 2
  - Start with lease liability
  - Adjusted for lease payments at or before the time that the lease started (deposits, future lease payments, etc.) that are related to future periods – these are reported as separate assets (Prepaid Assets) or Deposits
  - Less lease incentives received at or before the start of the lease
  - Add initial direct costs that are ancillary charges necessary to place asset into service
  - Do not include debt issuance costs which are expensed

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Initial Reporting - Lessor

- Recognize lease receivable - this is step 1
  - PV of payments received over lease term
  - Deduct any estimated uncollectible amounts
  - Includes some variable payments that are fixed in substance or that can be calculated at beginning of lease based on a rate or index (use rate or index at beginning of lease term), but not payments based on volume of usage
  - Deduct lease incentives payable to the lessee
  - Includes certain payments of residual value guarantees that are fixed in substance
- Payments related to purchase options and lease termination penalties should be recognized when they occur
- Residual value guarantees that are not fixed should be recognized as a receivable and deferred inflow of resources if a payment is required and the amount can be reasonably estimated

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Initial Reporting – Lessor (cont.)

- Recognize deferred inflow of resources – this is step 2
  - Start with the initial measurement of the lease receivable
  - Adjusted for lease payments at or before the start of the lease (deposits, future lease payments, etc.) related to future periods
  - Less lease incentives paid at or before start of lease
- Lessor should not derecognize asset underlying the lease
  - Accounting for depreciation and impairments continue
  - If asset must be returned in original condition, do not depreciate
- Initial direct costs (e.g., administrative set-up costs) are reported as outflows (expenses)

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Subsequent Reporting - Lessee

- Lease asset amortized in a systematic and rational manner
  - Shorter of lease term or underlying life of asset
  - Can use any amortization method – straight-line will be most common
  - Reported as amortization expense or may be combined with depreciation expense
  - If lease contains purchase option that lessee is reasonably certain to exercise:
    - Amortize over useful life of asset
    - For non-depreciable assets, no lease amortization

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Subsequent Reporting – Lessee (cont.)

- Discount on present value is amortized in a systematic way as an outflow of resources (interest expense)
  - Interest method is used – straight-line is not an option
  - Payments are allocated to principal and then interest
- This amortizes the lease liability

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Subsequent Reporting - Lessor

- Discount on receivable amortized as interest revenue at a constant periodic rate of return (interest method – no use of straight-line) – payments allocated to interest first and then the lease receivable
- Deferred inflows of resources recognized as inflows of resources (revenues) over lease term in a systematic and rational manner
- Depreciation of asset continues (if applicable) and impairments recognized (if necessary)
- Asset should not be de-recognized until the purchase option is recognized

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Governmental Funds

- Governmental Fund accounting – current financial resources measurement focus
  - Similar entries to current GAAP
  - Remember budgetary implications
- Lessees
  - Expenditure and other financing source recognized at present value of lease payments in period that lease is initially recognized
  - Expenditures for debt service payments consistent with debt service payments on other long-term debt

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Governmental Funds (cont.)

- Lessors
  - Recognize a lease receivable and a deferred inflow of resources
  - Deferred inflow of resources would be the initial value of the lease receivable plus any payments received at or before the start of the lease related to future periods
  - Deferred inflows of resources recognized as inflows of resources in a systematic and rational manner over the lease term

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Discount Rate - Lessee

- Interest rate the lessor charges the lessee – must look for this first
  - Implicit rate in the lease
  - Fair value of asset(s) can be used to impute a discount rate
- If lessor's rate can not be readily determined – lessee's incremental borrowing rate may be used
  - Lessee's rate to borrow a similar amount
  - Look at lease term
  - Will vary between governments based on credit ratings, lease term, type of asset, etc.
  - Affected by market interest rates

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Discount Rate - Lessor

- Discount rate is the rate the lessor charges the lessee
  - May not be the stated rate in the lease
  - Use of GASB 62 provisions for imputing an interest rate are optional
- The lease receivable should be remeasured using the revised discount rate in the event of a change in the discount rate

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Lease Incentives

- Payments made to or on behalf of the lessee which offset the obligation to the lessor or are other concessions granted to the lessee
- Includes lease payment reductions, lease holidays, reductions in lessee payment costs, etc.
- Lease incentives at or before the start of a lease reduce the value of the lease asset
- Lease incentives after the start of the lease have the effect of reducing the lease payments and the initial lease liability for the lessee and the lease receivable for the lessor
- Improvements to property by a lessor are not considered lease incentives because they do not affect payments

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Cell Tower Leases

- Cell tower agreements
  - Treated the same as other agreements
  - Individual agreements will need to be reviewed – if you have seen one agreement, you have seen one agreement
  - Many agreements lease physical assets and will be accounted for as leases under GASB 87 – see Question 4.7 in 2020 IG

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Nonlease Components

- Not included in calculation of lease liability
- Important to analyze leases and invoices before GASB 87 implementation to separate out nonlease components – otherwise, the entire cost is included in the lease liability
- This includes taxes, insurance, CAM, maintenance, other services
- Costs may be allocated for different components using whatever information is available and professional judgment

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Lease Modifications

- Modifying the provisions of an existing lease (amendment) outside of the provisions in the existing agreement
- Exercising an existing option within a lease agreement is subject to the guidance for remeasurement
- If the right to use the underlying asset(s) decrease(s) – full or partial lease termination
- In some situations, a lease modification may be accounted for as a separate lease

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Lease Modifications – Separate Lease

- Some amendments during a year are required to be accounted for as a separate lease
- Separate lease accounting required if both of the following exist:
  – One or more assets were added that were not included in the original lease contract
  – Increase in lease payments is not unreasonable (if unreasonable, it will not be considered to be a separate lease)

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Lease Modifications - Lessee

- Unless a lease amendment is treated as a separate lease
  – Remeasure lease liability in accordance with the requirements for initial measurement
  – Adjust lease asset - the adjustments are commonly the same amount
  – Lease asset value should not be less than $0 – gain or loss may be required
  – Discount rate is updated

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Lease Modifications - Lessor

- Unless a lease amendment is treated as a separate lease
  - Remeasure lease receivable in accordance with the requirements for the initial measurement
  - Adjust deferred inflow of resources - the adjustments are commonly the same amount
  - Discount rate is updated

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Lease Remeasurement - Lessee

- Lease remeasurements may be caused by:
  - Change in lease term
  - Change in payments included in the lease liability
  - Change in likelihood of residual value guarantee being paid
  - Change in interest rate charged by lessor if it is the discount rate
  - Change in likelihood of exercise of purchase option
  - Change in a contingency affecting the lease liability
- Remeasure lease liability and lease asset for material changes
- Update indexes or rates for variable payments for remeasurement; however, remeasurement is not required solely for a change in a rate or index used to calculate variable payments
- A change only in a lessee's incremental borrowing rate does not require remeasurement

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Lease Remeasurement - Lessor

- Lease remeasurements may be caused by:
  - A change in the lease term
  - A change in the rate the lessor charges the lessee
  - A contingency is resolved allowing variable payments to become fixed and they can be included in the lease liability
- Remeasure lease receivable and deferred inflow of resources if there are material changes
- Changes in the lease receivable and the deferred inflow of resources are likely to be the same - recorded at time of remeasurement
- Update the rate or index used for variable payments if remeasuring
- Remeasurement is not required solely for a change in the rate or index for variable payments

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Lease Remeasurement – Lessor (cont.)

- Discount rate must be re-evaluated if:
  - There is a change in the lease term
  - There is a change in the interest rate the lessor charges the lessee
- If the discount rate is updated, the lease receivable and the deferred inflow of resources should be remeasured using the revised discount rate

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Lease Terminations

- Lease amendment during the reporting period that decreases the lessee's use of the underlying asset is a full or partial lease termination (e.g., lease term is shortened or underlying assets are reduced)
- Lessee
  - Reduces carrying value of lease liability and right to use asset
  - Recognize gain or loss for difference
- Lessor
  - Reduces carrying value of lease receivable and deferred inflow of resources
  - Recognize gain or loss for difference

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Materiality

- Should review capitalization thresholds - the GASB specifically discussed a separate capitalization threshold for leases
- Materiality for lease liabilities should be evaluated as well
  - May be a different and lower threshold
  - Consider materiality when lease liabilities are remeasured
- Must discuss these issues with independent auditors
- New IG question clarifies that materiality applies to groups of similar assets (library books, computers, etc.) in which materiality must be evaluated for group totals

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Implementation

- Implementation for periods beginning after 6/15/21
  - FYE 6/30/22
  - Retroactive restatement required for all prior periods presented
  - If restatement is not practicable, restate beginning net position amounts for first year presented – for NC this means restate 7/1/21 and amortize
  - Disclose the nature of the restatement and its effect

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Other Implementation Issues

- Implementation should be on the first day of the earliest fiscal year presented
- All leases should be evaluated as they stand on that day – do not look back to inception of the leases
  - Lease liability measured using remaining lease term and discount rate at beginning of implementation
  - Right-to-use asset based on lease liability at implementation
  - Lease term and extensions determined at implementation – if lessee is reasonably certain to exercise lease extension – should be included in lease term
  - Short-term leases based on remaining lease term
- Review required note disclosures – be sure that accounting system will generate this information

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Other Implementation Issues (cont.)

- For existing capital leases:
  - Recalculate new lease liability
  - Lease asset is related to new lease liability
  - Adjustments are a PPA at implementation
- MD&A (also includes statistical section) – per Accounting Changes ED
  - MD&A amounts should be consistent with the statements presented
  - Do not restate amounts for periods before the statements presented
  - Explanation given in MD&A with cross-reference to note disclosure in financial statements for the accounting principle change

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GASB Statement No. 96

Subscription-Based Information Technology Arrangements (SBITA)

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Definition of SBITA

- "Contract that conveys control of the right to use another party's information technology software…"
  - Could be alone or in combination with other tangible capital assets
- Standard based on similar guidance from Statement No. 87, *Leases*

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SBITA Term

- Specified use period identified in the contract (noncancellable period)
  - Includes the period of time, if applicable, to use underlying IT assets
  - Includes option to extend periods (if reasonably expected)
  - Includes option to terminate (if NOT reasonably expected)

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General Guidance

- Lessee should recognize right-to-use SBITAs as intangible assets and a corresponding subscription liability
- Liability initially measured at the PV of payments to be made throughout the term
  - Payments discounted using the interest rate charged or incremental borrowing rate if interest not implicit
  - Payments expensed over term
- Short-term SBITAs (e.g., max term of one year or less) expensed as payments are made (cancellable periods can affect the term)

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General Guidance (cont.)

- Asset should be initially measured at the initial liability amount
  - Add any payments made before commencement
  - Add any capitalizable implementation costs
  - Amortize the asset over the lease term or the useful life of the underlying assets, whichever is shorter

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Other Accounting Guidance

- Preliminary project stage activities are simply expensed (research, selecting a vendor, etc.)
- Implementation stage activities should be capitalized as an addition to the asset
- Subsequent maintenance, further implementations, etc. should be expensed as incurred (with some exceptions)
- Training costs always expensed

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Implementation

- Effective for fiscal years beginning after June 15, 2022 (FYE 6/30/23 in NC)
- Earlier application encouraged
- Assets/liabilities should be measured using the facts/circumstances that existed at the beginning of the fiscal year of Statement implementation

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Exposure Draft – Compensated Absences

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Compensated Absences

- Amendment to GASB Statement No. 16
- Liability recognized if the absence:
  - Accumulates (carries forward to a future reporting period)
  - Is attributable to services already rendered
  - Is more likely than not to be paid or settled through other means
- Liability amount:
  - Based on employee's pay rate at reporting date – future pay changes recognized prospectively
  - Includes both direct and incrementally-associated salary-related payments (employer's share of SS and Medicare taxes)
- Common in NC: vacation leave, sick leave, comp. time

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Compensated Absences (cont.)

- Accumulated leave that is more likely than not to be paid through conversion to postemployment defined benefits would not be included
- Amounts paid to individual accounts treated differently
- FIFO assumption for estimating amount due within a year
- Current financial resources measurement focus – expenditure and liability recognized as payments come due each period – guidance from GASB Interpretation #6 carried over (will be superseded by new reporting model)

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Compensated Absences (cont.)

- Note disclosure changes
  - Net change in liability may be disclosed – previously was additions and deductions
  - Do not have to disclose which governmental funds were used to liquidate liability
- Implementation
  - Periods beginning after 12/15/22 – 6/30/24 FYE in NC
  - Retroactive restatement required if practical

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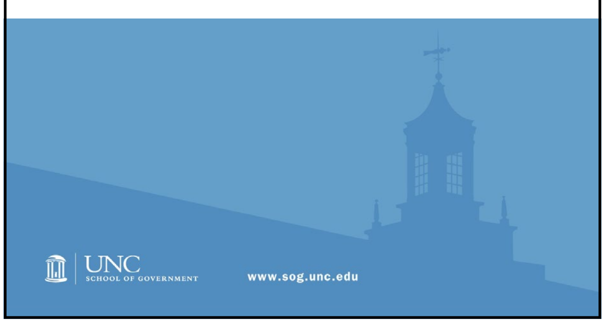
Exposure Draft - Financial Reporting Model Improvements



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Financial Reporting Model

- Encompasses review of MD&A, government-wide statements, governmental / proprietary / fiduciary funds, and budgetary considerations
- Exposure Draft issued June 2020
- Final standard anticipated June 2022

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Highlights

- MD&A
  - Some items eliminated (budgetary, modified approach)
  - Reduction in boilerplate language emphasized
  - Duplication – reduce through cross-referencing
  - Currently known facts, decisions, or conditions – more specific requirements
  - Improve on analysis

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Highlights (cont.)

- Changes for special & extraordinary items – unusual or infrequent items
- New MFBA for Governmental Funds – short-term measurement focus, accrual basis of accounting
- Governmental Fund Financial Statements – current and noncurrent activity format
- Proprietary Fund Financial Statements – presentation change to show noncapital subsidies

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Highlights (cont.)

- Major component units – present in Basic Financial Statements in separate columns if readability is not impacted
- Budgetary comparisons – RSI required
- Financial trends information –revenues by major source for business-type entities

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Potential Implementation Timeline

- Two-tier phased-in approach with thresholds determined by FYE 6/30/23 (NC) – first fiscal year after 6/15/22
  - $75 million or more in revenue for governmental and business-type activities
    - Implement FYE 6/30/25
  - $75 million or less in revenue for governmental and business-type activities
    - Implement FYE 6/30/26
  - All parts of reporting entity implement together based on primary government
- GASB is struggling with due process on this project

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Preliminary Views – Revenue and Expense Recognition

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Background

- Revenue recognition for exchange transactions – measurable & earned
- FASB changed this with the implementation of Revenue Recognition from Contracts with Customers – idea of performance obligations
- Changes in revenue and expense classifications needed for reporting model changes
- New model moves away from classifying transactions as exchange, exchange-like and nonexchange

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AB Model

- Category A – performance obligations
  - Binding arrangement
  - Parties to transaction have approved terms of binding arrangement
  - Parties to the transaction have substantive rights & obligations
  - Substantive rights and obligations are interdependent
- Must meet all 4 criteria – otherwise Category B
- Applies to both revenues and expenses

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AB Model (cont.)

- Category B – 5 categories
  - Derived revenue
  - Imposed revenue
  - Contractual binding arrangement
  - General aid to governments
  - Shared revenue
- Purpose restrictions still do not affect revenue recognition – much discussion of this in due process
- Revenues recognized net of refunds and uncollectibles

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Revenue and Expense Recognition

- Preliminary Views issued in June 2020
- Exposure Draft anticipated June 2023
- Final standard anticipated September 2024
- GASB is struggling with due process on this project

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