GASB 87 Testing Strategy – Leases

GASB Statement No. 87 is effective for fiscal years ending on or after June 15th, 2022. As the original statement is amended, and for the extensive number of implementation guide questions, the most reliable source of accounting guidance is found in the GASB Codification – L20 Leases.

This statement replaces previous lease guidance, eliminating the concept of capital and operating leases. A foundational principal of this statement is that a lease is a financing for the right to use an underlying asset. Activity that formerly only had an operating statement effect, may now result in long-term assets, liabilities, and deferred inflows.

Determining if contracts will be subject to GASB 87 reporting will be based on an analysis of the contract terms (the substance) and not dependent on the contracts vocabulary (the form). Contracts which use the term *lease* may not be subject to GASB 87, while others that do not use that term (especially for embedded leases), may be applicable.

Auditors evaluating or testing this area should consider the following training:

SAO Training System ➔ Self-Study ➔ Accounting/Auditing

- GASB 87 – Leases GAAP Basis (2021)
- GASB 87, 94 & 96 (2020)

The auditor should be alert to the following potential circumstances not addressed in the testing strategy:

- Contracts with multiple components (¶63-68)
- Contract combinations (¶69-71)
- Lease modifications and terminations (¶71-79)
- Subleases (¶80-81)
- Sale-leaseback transactions (¶82-86)
- Lease-leaseback transactions (¶87)
- Intra-entity leases (¶88-89)
- Leases between related parties (¶90-91)
- Lease remeasurement

NOTE: When using the "GASB 87 Lease Calculation Tool" valid variances may exist – when variances are due to valid differences, the auditor should in most cases (based on risk) accept the variance as correct (with explanation) rather than adjust the workpaper to perfectly recalculate expected or reported amounts. For incorrectly non-reported leases, the error should be estimated as the sum of all remaining payments – this is a conservatively high estimate, qualitatively the auditor should recognize that future payments discounted to the present would be less.

Contact Brandon Tecca for assistance, or if you have any questions on these procedures.

Key Definitions and Terms:

- **Lease** – A contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction.
- **Control criteria** – (1) The right to obtain (use) the present service capacity from use of the underlying asset and (2) the right to determine the nature and manner of it use.
  - *A lease contract may specify the allowable use of the underlying asset (such as office space for a job training program or sidewalk space for a food cart).*
    - *The right to "office space" is distinct from the right to "office training space". The right to determine the nature and manner of use may still be granted within a specified allowable use.*

- *The right does not have to be uninterrupted (i.e. a lease may be for 3 days per week).*
- *The right is considered distinct from the underlying asset itself, meaning that the asset itself may be replaced/substituted with essentially identical assets (such as equipment).*

- **Lease term** – The period during which a lessee has a non-cancelable right to use an underlying asset, plus periods covered by a lessee's or lessor's option to extend the lease (if reasonably certain the option will be exercised) and periods covered by the lessee's or lessor's option to terminate the lease (if reasonably certain the option will not be exercised). Periods for which both the lessee and the lessor have an option to terminate the lease without permission from the other party, or if both parties have to agree to extend, are excluded from the lease term.
  - *The lease term is a question of probability. An applicable lease may be determined to have a nine month lease term because the periods to extend were evaluated as being "not reasonably certain" of being exercised. A lease term of less than 12 months is not automatically a short-term lease (defined below).*

- **Reasonably certain** – GASB determined the probability threshold of *more likely than not* and *probable* was too low, and that *virtually certain* was too high. As more than probable, this is considered to be a high degree of probability (such as ~90%+).
  - *Determining this probability will be a matter of professional judgment and should include all relevant factors, for example: economic incentives, market conditions, contract terms, asset-based considerations, and government specific factors.*

- **Incremental borrowing rate** – The rate of interest that a borrower would have to pay to finance an asset of that same type, over a similar term, in the current economic environment, and of a similar value as the right-of-use intangible (lease) asset.
  - *This is the borrowing rate at the margin for new debt, and not necessarily the rate of other previously negotiated debt (which may have a dissimilar borrowing profile).*

- **Variable payments which are fixed in substance** – These are variable payments which have a set minimum component (which is regardless of any use or future performance) (¶45).
  - *Purely variable amounts are excluded even when the entity can reasonably estimate what this amount will be (Q 4.28). However, fixed payments included in the contract which are not part of the assets value (such as for janitorial services) are not included (Q 4.60).*

Activity exempt from the scope of GASB 87:

- Short-term leases – Leases that have at the commencement of the lease, a maximum possible term of 12 months or less, including any options to extend, regardless of their probability of being exercised (such as month-to-month leases). The lease payments will simply be recognized as revenue by the lessor and expenses by the lessee.
  - *The short-term lease determination is not a question of probability. All future options to extend are counted, regardless of probability. Exercised options grant the non-cancelable right to extend the contract for a stated period of time. While month-to-month leases may persist for years, since those future periods are cancelable by either party, they are not counted towards the lease term.*

- Contracts that transfers ownership (formerly classified as a capital lease) – A contract that transfers ownership of the underlying asset to the lessee by the end of the contract and does not contain termination options should be reported as a financed purchase by the lessee or a sale by the lessor.
  - *A purchase option which is reasonably certain of being exercised is still reported as a lease.*

- Intangible assets – Such as mineral rights, patents, or copyrights. Leases of IT hardware is covered by GASB 87, but software leases are not and would be considered an intangible asset.

- Biological assets – Such as timber, living plants, living animals. Land leased for farming or hunting is not exempt; the land is the underlying asset.

- Leases of inventory
- Service concession arrangements which are covered by GASB 60; subscription-based information technology arrangements (SBITA) covered by GASB 96; public-private and public-public partnerships covered by GASB 94
- Assets financed with outstanding conduit debt – Unless both the asset and conduit debt are reported by the lessor
- Supply contracts – Such as power purchase agreements
- Certain regulated leases (as the lessor) – Such as aviation leases between airports and air carriers (when the lease terms are regulated by the FAA, see ¶42.43). **Certain disclosure requirements still apply.**
- Nonexchange transactions covered by GASB 33 – Such as leasing property for 1$
- Leases of assets that are classified as investments – If the underlying asset meets the requirement in GASB 72 to be reported as an investment measured at fair value (**disclosure requirements in paragraph 57 (d <u>only</u>) still apply**).

Step 1: Gain Understanding of Internal Controls

If lease balances are identified as material, then gain an understanding of internal controls over lease reporting in the permanent file folder.

<u>Expected key controls</u> for all assertions are as follows:

- Assigned staff have performed the research or taken training as needed to gain a sufficient understanding to implement GASB 87.
- The entity has performed the appropriate steps to identify all applicable leases (completeness).
    - *Governments may have a significant number of leases administered decentrally across the organization. Non-finance departments in particular may need training on identifying their leases (as defined by GASB 87).*
    - *Components of a larger contract may also meet the definition of a lease (an embedded lease); these leases may not be readily identifiable as these contracts may include primarily non-lease activity.*
- The entity has a process for determining an appropriate <u>discount rate</u>.
    - *Allowable methods for lessor:*
        - *The rate the lessor charges the lessee (which may be the rate implicit in the lease)*
            - *Leases may contain a stated and reasonable interest rate*
            - *Or by imputation of interest as described in in ¶173–187 of [Statement 62]*
        - *The estimated lessee's incremental borrowing rate*
        - *If it is not practicable (reasonably possible) to use the above methods, the lessors own incremental borrowing rate may be used.*
    - *Allowable methods for lessee:*
        - *The rate the lessor charges the lessee (which may be the rate implicit in the lease)*
            - *Leases may contain a stated and reasonable interest rate*
            - *Or by imputation of interest as described in in ¶173–187 of [Statement 62]*

        - *If the interest rate cannot be readily determined by the lessee, the lessee's own estimated incremental borrowing rate may be used.*

      In practice, most governments will start with a bank prime rate or a Treasury bill rate (with similar length). Using the LGIP rate would be unreasonable because it is not a borrowing or financing rate.

- Entity has documented leases and relevant attributes and calculations in accounting software, spreadsheets or other centrally maintained and standard documentation.
- For lessees – the entity has determined an appropriate capitalization threshold for intangible lease assets <u>or</u> for expensing lease liabilities which are not significant either individually or in the aggregate.
    - *See question 7.4.1 and 7.9.8 the Comprehensive Implementation Guide.*

Step 2: Evaluate the Completeness and Existence of Lease Activity

- Obtain the population of lease contracts the government has determined were subject to GASB 87.
    - Evaluate whether this list appears complete based on our understanding of the entity and operations.
        - Based on risk, the auditor may consider scanning vendor payments or revenue accounts (such as in charges for goods and services) to identify potential lease activity.

          Embedded leases may exist in primarily non-lease contracts.
        - Scan leases identified by the entity to determine if any of the contracts appear to be excluded from GASB 87.
- Inquire about contracts which the entity has determined are excluded from the scope of GASB 87.

  This includes short-term leases, leases the government have determined fall below a lease capitalization threshold, and all other items noted in exceptions/exclusions above.
    - Based on risk, consider selecting a sample of contracts to determine if they were appropriately excluded.

      In particular, the entity may not have correctly applied the short-term lease, regulated lease, or intangible-asset exclusions.

STEP 3(a): Test LESSOR Accounting (if applicable)

Based on the materially of lessor operations and composition of selected material balances, determine an appropriate selection of lessor contracts to test. The auditor will need to obtain the contracts to verify the terms and payment schedules are accurate. The accounting is the <u>same</u> for both full and modified accrual.

Auditors may use the [GASB 87 Calculation Tool] to assist in recalculating the figures. See the appendix for additional guidance. Alternatively, auditors could document tests by tick-marking client worksheets. The auditor should consider performing a judgmental sample (e.g. one lease from each group or major type, plus any that are individually significant or appear high risk).

Perform the following tests for selected contracts:

- Determine if the lease term is correctly identified (see definitions).
- Determined the discount rate is reasonable (see step 2).

- Recalculate the **lease receivable** (or review the entities calculations).

  A lessor initially should measure the lease receivable at the present value of lease payments expected to be received during the lease term, reduced by any provision for estimated uncollectible amounts. Measurement of the lease receivable should include the following, if required by a lease:
  - Fixed payments
  - Variable payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate as of the commencement of the lease term)
  - Variable payments that are fixed in substance (as discussed in ¶45)
  - Residual value guarantee payments that are fixed in substance (as discussed in ¶46)
  - Any lease incentives (as discussed in ¶ 61 and 62) payable to the lessee.

- The reported lease receivable should be reduced by any provision for estimated uncollectible accounts (¶44).

  Not all governments are expected to have a history of uncollectible lease receivables.

- Recalculate the **deferred inflow** of resources (or review the entities calculations).

  A lessor initially should measure the deferred inflow of resources as follows:
  - The amount of the initial measurement of the lease receivable.
  - Lease payments received from the lessee at or before the commencement of the lease term that relate to future periods (for example, the final month's rent), less any lease incentives (as discussed in ¶61 and 62) paid to, or on behalf of, the lessee at or before the commencement of the lease term.

  A lessor subsequently should recognize the deferred inflow of resources in a systematic and rational manner over the lease term (¶20).

- Recalculate the **lease revenue** (or review the entities calculations).

  Each period, deferred inflow is reduced and recognized as revenue. Governments may recognize revenue as the amount of the principal payments (the interest method) or use straight-line.

- Recalculate the **lease interest** revenue (or review the entities calculations).

  The recognized interest for each payment should be based on the current value of the receivable (the interest method) and may not be straight-line.

  For proprietary funds, lease interest is always expected to be reported as nonoperating.

Step 3(b): Test LESSEE Accounting (if applicable)

Based on the materially of lessee activity and composition of selected material balances, determine an appropriate selection of lessee contracts to test. The auditor will need to obtain the contracts to verify the terms and payment schedules are accurate. These procedures make distinctions between the accounting in full vs. modified accrual (where applicable).

Auditors may use the [GASB 87 Calculation Tool] to assist in recalculating the figures. See the appendix for additional guidance. Alternatively, auditors could document tests by tick-marking client worksheets.

Perform the following tests for selected contracts:

- Determine if the lease term is correctly identified (see definitions).

- Determined if the discount rate is reasonable (see step 2).
- Recalculate the **<u>lease liability</u>** (or review the entities calculations).

  A lessee initially should measure the lease liability at the present value of payments expected to be made during the lease term. Measurement of the lease liability should include the following, if required by a lease:
  - Fixed payments
  - Variable payments that depend on an index or a rate (such as the Consumer Price Index or a market interstate), initially measured using the index or rate as of the commencement of the lease term
  - Variable payments that are fixed in substance (as discussed in ¶22)
  - Amounts that are reasonably certain of being required to be paid by the lessee under residual value guarantees
  - The exercise price of a purchase option if it is reasonably certain that the lessee will exercise that option
  - Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising (1) an option to terminate the lease or (2) a fiscal funding or cancellation clause
  - Any lease incentives (as discussed in ¶61 and 62) receivable from the lessor
  - Any other payments that are reasonably certain of being required based on an assessment of all relevant factors.

  Under **modified accrual**, at inception, the entity should recognize an "other finance source" (for the "issuance of new debt") and a capital outlay expenditure (both in the amount of the long-term debt).

  Under **modified accrual**, similar to other long-term debt, this liability will <u>not</u> be reported.

- Recalculate the **<u>intangible right-to-use lease asset</u>** (or review the entities calculations).

  A lessee initially should measure the lease asset as the sum of the following:
  - The amount of the initial measurement of the lease liability (see ¶21)
  - Lease payments made to the lessor at or before the commencement of the lease term, less any lease incentives (as discussed in ¶61 and 62) received from the lessor at or before the commencement of the lease term
  - Initial direct costs that are ancillary charges necessary to place the lease asset into service.

  The lease asset should be amortized in a systematic and rationale manner (straight-line is allowed) over the shorter of the lease term or the useful life of the underlying asset.
  - If the asset contains a purchase option that the lessee has determined is reasonably certain of being exercised, the lease asset should be amortized over the useful life of the underlying asset. If in this circumstance the underlying asset is non-depreciable, such as land, the lease asset should not be amortized.

  Under **modified accrual**, similar to other capital assets, this asset will <u>not</u> be reported.

- Recalculate the **<u>interest expense</u>** (or review the entities calculations).

  The difference between the sum of all the payments (as determined by the lease term) and the value of the liability at inception should be recognized over the lease term. The recognized interest for each payment should be based on the current value of the payable (the interest method) and may not be straight-line.

Under **modified accrual**, this will be classified as "debt service – interest".

Differences are likely to exist between full accrual interest expense and modified accrual (which generally recognizes the expense when due).

For government-wide statements and proprietary funds, the payment of debt principal is <u>not</u> an expense, this calculation will still be a component of determining the FYE ending lease liability.

For **modified accrual**:

- Recalculate the **<u>debt service principal expenditure</u>** (or review the entities calculations)

  For each payment, the debt service principal will be the total of the payment less the amount recognized as interest. If the lease interest calculation is greater than the payment (this should be rare) then an interest payable should be recognized. All payments should be applied to interest/interest payable prior to recognizing any principal payment.

  The lease liability should be reduced by the amount of the calculated debt service principal.

- If the year of lease inception (not the year of implementation), recalculate the **<u>other financing source and capital outlay</u>** (or review the entities calculations)

  The capital outlay should tie to the amount of the asset while the other financing source should tie to the amount of the lease payable (these two amounts may be different).

Step 4(a): Review LESSOR Note disclosures (if applicable)

As described in the Note Disclosures step in TeamMate, determine whether lessor disclosures are complete, accurate, properly classified, valued, understandable, and in accordance with GAAP by:

- Footing and cross-footing notes and tracing key figures reported to the financials, underlying accounting records, and other sources, as applicable.
- Checking that all required disclosures were made and reading them to determine whether they are accurate and in accordance with GAAP.

*The BARS manual has **<u>not yet be updated</u>** for GASB 87 and should not be used by entities that have early-implemented. A summary of required disclosures for lessors (which may be grouped and would not include short-term leases) is as follows:*

Note Disclosures	(Yes/No/NA)	Notes
A general description of its leasing arrangements, including the basis, terms, and conditions on which any variable payments not included in the measurement of the lease receivable are determined		
The total amount of inflows of resources (for example, lease revenue, interest revenue, and any other lease-related inflows) recognized in the reporting period from leases, if that amount cannot be determined based on the amounts displayed on the face of the financial statements		

The amount of inflows of resources recognized in the reporting period for variable and other payments not previously included in the measurement of the lease receivable, including inflows of resources related to residual value guarantees and termination penalties		
The existence, terms, and conditions of options by the lessee to terminate the lease or abate payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments.		
A lessor also should provide relevant disclosures for the following transactions, if applicable:		
○ Leases of assets that are investments (see paragraph 41)		
○ Certain regulated leases (see paragraph 60)		
○ Sublease transactions (see paragraph 81)		
○ Sale-leaseback transactions (see paragraph 85)		
○ Lease-leaseback transactions (see paragraph 87).		
In addition to the disclosures in paragraphs 57 and 58, if a lessor's principal ongoing operations consist of leasing assets to other entities, the government should disclose a schedule of future payments that are included in the measurement of the lease receivable, showing principal and interest separately, for each of the five subsequent fiscal years and in five-year increments thereafter.		
A lessor with one or more regulated leases, as described in paragraphs 42 and 43, should disclose the following about those lease activities (which may be grouped for purposes of disclosure), other than short-term leases:		
○ A general description of its agreements		
○ The extent to which capital assets are subject to preferential or exclusive use by counterparties under agreements, by major class of assets and by major counterparty		
○ The total amount of inflows of resources (for example, lease revenue, interest revenue, and any other lease-related inflows) recognized in the reporting period from these agreements, if that amount cannot be determined based on the amounts displayed on the face of the financial statements		
○ A schedule of expected future minimum payments under these agreements for each of the subsequent five years and in five-year increments thereafter		
○ The amount of inflows of resources recognized in the reporting period for variable payments not included in expected future minimum payments		
○ The existence, terms, and conditions of options by the lessee to terminate the lease or abate lease payments if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments.		

Step 4(b): Review LESSEE Note disclosures (if applicable)

As described in the Note Disclosures step in TeamMate, determine whether lessor disclosures are complete, accurate, properly classified, valued, understandable, and in accordance with GAAP by:

- Footing and cross-footing notes and tracing key figures reported to the financials, underlying accounting records, and other sources, as applicable.
- Checking that all required disclosures were made and reading them to determine whether they are accurate and in accordance with GAAP.

*The BARS manual has **not yet be updated** for GASB 87 and should not be used by entities that have early-implemented. A summary of required disclosures for lessors (which may be grouped and would not include short-term leases) is as follows:*

Note Disclosures	(Yes/No/NA)	Notes
A general description of its leasing arrangements, including (1) the basis, terms, and conditions on which variable payments not included in the measurement of the lease liability are determined and (2) the existence, terms, and conditions of residual value guarantees provided by the lessee not included in the measurement of the lease liability		
The total amount of lease assets, and the related accumulated amortization, disclosed separately from other capital assets		
The amount of lease assets by major classes of underlying assets, disclosed separately from other capital assets		
The amount of outflows of resources recognized in the reporting period for variable payments not previously included in the measurement of the lease liability		
The amount of outflows of resources recognized in the reporting period for other payments, such as residual value guarantees or termination penalties, not previously included in the measurement of the lease liability		
Principal and interest requirements to maturity, presented separately, for the lease liability for each of the five subsequent fiscal years and in five-year increments thereafter		
Commitments under leases before the commencement of the lease term		
The components of any loss associated with an impairment (the impairment loss and any related change in the lease liability, as discussed in ¶34).		
A lessee also should provide relevant disclosures for the following transactions, if applicable:		
o Sublease transactions (see ¶81)		
o Sale-leaseback transactions (see ¶85)		
o Lease-leaseback transactions (see ¶87).		
A lessee is not required to disclose collateral pledged as a security for a lease (under ¶113 of Statement 62) if that collateral is solely the asset underlying the lease.		

Appendix – Journal Entries

Inception of lease:			
	Assets	Liabilities	Deferred Inflows
Lessee	Intangible "right to use" Lease Asset – measured as the sum of the initial measurement of the lease liability, plus any initial direct costs and lease payments made prior to the start of the lease, less any lease incentives.	Lease Liability – initially measured at the present value of payments expected to be made during the lease term, including fixed payments, variable payments based on an index, reasonably certain residual guarantees, etc.	
Lessor	Lease Receivable – initially measured at the present value of lease payments expected to be received during the lease term.		Deferred Inflow – measured as the sum of the initial measurement of the lease receivable, plus any lease payments received prior to the start of the lease, less any lease incentives.
The lessor continues to report the leased capital asset.			

Subsequent activity:			
	Assets	Liabilities	Deferred Inflows
Lessee	Lease Asset – amortize over shorter of useful life or lease term.	Lease Liability – reduce by principal portion of lease payments (recognize interest expense portion of payments as a non-operating expense).	
Lessor	Lease Receivable – reduce by principal portion of lease payments (recognize interest income portion of payments as a non-operating revenue).		Deferred Inflow – recognize revenue over the lease term in a systematic and rational manner.
Lessor continues to depreciate the leased asset over its useful life (unless it has an indefinite useful life or is required to be returned in its original or enhanced condition).			

Governmental-type funds, Lessee only (see ¶10, 35, 36, 56, B53)			
Inception of lease	Capital Outlay - measured at the present value of payments expected to be made during the lease term, including fixed payments, variable payments based on an index, reasonably certain residual guarantees, etc.	Other Financing Sources – Issuance of Debt - measured at the present value of payments expected to be made during the lease term, including fixed payments, variable payments based on an index, reasonably certain residual guarantees, etc.	
Subsequent payments	Debt Service Principal Debt Service Interest		