LOCATION IN TEAMMATE STORE:

Cabinet: **Financial Statements**

Folder: **School F196 Statements**

Sub-Folder: **Review Presentation & Disclosure**

Step Name: Implementation of Accounting Changes 2022

PURPOSE/CONCLUSION TAB:

Purpose:

To determine if relevant accounting changes have been properly implemented for FY22 statements.

Conclusion:

The district implemented the following significant accounting changes for FY22:

- Lease Reporting

We determined these accounting changes were properly implemented. [or note exceptions]

TESTING STRATEGY TAB:

Prior to working on this step, auditors should obtain an appropriate understanding of lease reporting for school districts, such as by:

- Reading key sections of the SDAM:
  - Accounting Guidelines – Debt and Leases, Chapter 3, pages 34–53
  - Journal Entries for Leases, Chapter 7, pages 45–49
- Auditors could also take the GASB 87 Leases – GAAP Basis training as an introduction to leases. The accounting is the same for modified accrual (however, the full accrual portions would not apply).

New accounting guidance in the School District Accounting Manual (SDAM) and changes to the Administrative Budgeting and Financial Reporting (ABFR) guidance (for note templates) are either factored into existing steps, or when significant, addressed here for implementation testing.

Auditors are **required** to perform the following procedures to evaluate the implementation of new accounting requirements:

- Review relevant results of central data analysis to factor into testing.

  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.*

STEP 1: Identification of relevant new accounting requirements – FY 2022

We have centrally identified and evaluated the impacts of SDAM and ABFR changes; these changes requiring an audit response have been centrally determined — no additional identification procedures are expected for this step.

As discussed in the accounting/guidance tab, not all accounting changes are relevant to the audit.

During the Risk Assessment Inquiry step, the auditor should be inquiring with key personnel regarding implementation of new accounting standards to confirm expectations and help assess risk and significance. Auditors should also be alert during the course of the audit for further information regarding the applicability and significance of new requirements. ***Contact Ryan Montgomery and Brandon Tecca if other accounting changes are identified as risks, while not expected, unusual circumstances could make other changes uniquely significant.***

The accounting bulletins frequently create and modify accounting codes (which may be identified when performing financial trends in planning); these changes are not typically expected to result in the identification of a relevant audit risk.

STEP 2: Understand overall controls over new accounting requirement implementation

- **Obtain an understanding of overall general controls established to identify and implement new accounting requirements.**

  We would expect overall controls over implementation of new accounting standards would include:
  - *One or more key personnel are alerted to new requirements.*
  - *Key personnel read new accounting guidance.*
  - *Documented conclusions regarding applicability of new guidance and – as needed - implementation plans are developed to support financial statement preparation.*

  Weaknesses in overall controls over new accounting guidance implementation should be evaluated in the same manner as any other control deficiency. However, we would not expect weaknesses in overall controls to be a significant deficiency unless combined with specific weaknesses in implementation of new guidance.

  Specific controls should be designed for implementation of each new standard, which may need to be evaluated in connection with overall controls to the extent the new standard is material. Additional expectations are documented in the RWD specific to the identified relevant changes.

- **Obtain an understanding of controls specific to correctly reporting these new accounting changes.**

  - The district has performed the appropriate steps to identify all applicable leases (completeness).
    - *Districts may have a number of leases administered decentrally across the organization.*
    - *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 district has a process for determining an appropriate discount rate (does not apply to Cash basis).

The discount rate (interest rate) is used to calculate the present value of the contractual obligation. It is the interest rate the lessor charges the lessee. This rate is often not stated in lease agreements. It may be the rate implicit in the lease. If the lease's implicit rate is not readily determinable, the lessee's estimated incremental borrowing rate should be used. This is the rate the lessee would be charged for borrowing the lease payment amounts during the lease term. Documentation of methods and sources used to determine the discount rate for each lease agreement should be retained.

In practice, most districts will start with the LOCAL program rate, a bank prime rate, or a Treasury bill rate (with similar length) then adjust accordingly. Using the LGIP rate would be <u>unreasonable</u> because it is not a borrowing or financing rate.

- District has documented leases and relevant attributes and calculations in accounting software, spreadsheets or other centrally maintained and standard documentation.

- For lessees – the district 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 (SDAM 3–52).

  Leases excluded from lease reporting due to these thresholds still have to be <u>tracked</u> and evaluated every year to ensure aggregate totals remain insignificant. If the aggregate total of all leases is obviously trivial then districts may exclude the total without determining an individual threshold. However, setting a specific threshold in the future, or changing any threshold – if more leases are entered into – could trigger lease accounting recognition of leases previously excluded . For example, if the threshold is 20,000, a 15,000 lease may be excluded, but if the threshold is subsequently changed to 10,000 then the previously excluded lease (of 15,000) would have to be added to the schedule of liabilities (may be measured at the date of recognition or original inception); in this scenario an other financing source/capital outlay would not be reported since it occurred in a prior period.

<u>STEP 3: Evaluate Completeness and Existence of Lease Activity</u>

- Obtain the population of lease contracts the district has determined were subject to lease reporting.
  - Evaluate whether this list appears complete based on our understanding of the district and operations.
  - Based on risk, the auditor may consider scanning vendor payments or general ledger accounts to identify potential lease activity.

    Use the SDAM to see what general ledger accounts amounts are expected to be reported in. However, if leases are incorrectly reported then leases may be reported outside of these expected accounts.

- Inquire about contracts which the district has determined are excluded from the scope of lease reporting.

  This includes short-term leases, leases the government have determined fall below a lease capitalization threshold, and arrangements specifically excluded from lease reporting (SDAM 3-46).

- Based on risk, consider selecting a sample of contracts to determine if they were appropriately excluded.

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

STEP 4: Confirm Lease Valuations

- Judgmentally select leases to recalculate or review based on size while maximizing variability in the selection (i.e. lessor, lessee, for different types of underlying assets, etc.). The size of the selection should be based on risk and materiality.
  - To recalculate lease amounts, auditors may use the GASB 87 Lease Calculation Tool found in the GAAP workpaper folder.
  - To review lease calculations, confirm key figures (such as the discount rate) and determine the formulas are performing the correct calculations (or that the amortization tables are otherwise correct).

- For selected leases, auditors should start by obtaining the lease calculations (part of the amortization tables) and the lease contracts. The lease valuations are based on the terms of the contracts, for example: options to extend, variable payments which are fixed in substance, non-lease components, etc.

  Note: Cash basis districts do not use a discount rate to perform present value calculations for future payments. As a result, no interest revenue/expense is recognized and the value of lease liability is the sum of remaining payments. If using the Lease Tool to document work, set the discount rate to 0%.

STEP 5: Review Lease Disclosures

- Compare reported note disclosures to the ABFR to ensure disclosures are complete

  - Note 1: Summary of Significant Accounting Policies should describe the new lease accounting under Accounting and Reporting Changes.

    While part of the note template, if a district has no lease activity and removed this part of the template, we would not ask them to add it back in.

  - Note X: Leases

- Read for expected consistency with amounts and terms of tested contracts

- Foot tables

For assistance contact Ryan Montgomery or Brandon Tecca.

GUIDANCE/CRITERIA TAB:

ACCOUNTING STANDARD CHANGES

School District Accounting Manual (SDAM) changes are typically communicated to schools through a series of bulletins; these bulletins are classified as either revisions (for changes) or addendums (for new areas of guidance).

The Administrative Budgeting and Financial Reporting Guidance (ABFR) notes are also updated annually, these changes are not communicated through the bulletins.

SAO participates in the update process for the SDAM and ABFR note changes, as a result we are alert to changes prior to their communication to school districts.

Not all changes are significant to the audit (i.e. has no reasonable possibility of resulting in significant misstatements).

ADDITIONAL BACKGROUND

Implementation of new accounting standards is considered a change in accounting principle, to the extent the standard is applicable and results in a change to financial statement figures.

SAO's Financial Audit Committee (FAC) performs a central review of all new accounting standards. This review includes preliminary conclusions about the expected materiality of new standards that auditors can use as a starting point for planning purposes. This information is documented on the New GASB Tracker spreadsheet on the FAC SharePoint page. **Not all GASB statements are implemented for F196 reporting; the implementation of statements may also be modified for schools.**

Key Definitions and Terms (GAAP not SDAM references):

- **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).

- **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.

- **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). Examples of fixed-variable payments include:
  - Payments based on an index or rate, using the rate as of the beginning of the lease. For example, if the current rate is 2% then each year the payment would increase by 2%.
  - The minimum set portion of a variable charge. For example, $1 per mile with a minimum of $500, only the set $500 is counted because it is not based on use or future performance.

  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).

RECORD OF WORK DONE TAB:

Central Data Analysis

We reviewed results of central data analysis in [link to Schools FS Central Data Analysis] and identified [no / the following] risks to follow up on

STEP 1: Identification of relevant new accounting requirements – FY 2022

We have evaluated accounting changes to the School District Accounting Manual (SDAM) and Administrative Budgeting and Financial Reporting (ABFR) guidance, the following accounting changes have been identified as significant:

- Lease reporting

<u>STEP 2: Understanding of overall controls over new standards implementation</u>

In addition to controls over financial statement preparation as documented in the permanent file folder, we identified the following overall controls relevant to implementation of new accounting standards:

[see testing strategy for expected general implementation controls and note any weaknesses]

We also obtained an understanding of controls specific to correctly reporting these new accounting changes:

[see testing strategy for expected specific controls and note any weaknesses]

<u>STEP 3: Evaluate Completeness and Existence of Lease Activity</u>

<u>STEP 4: Confirm Lease Valuations</u>

<u>STEP 5: Review Lease Disclosures</u>