NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

JANET COWELL
TREASURER

T. VANCE HOLLOMAN
DEPUTY TREASURER

Memorandum #2011-1

TO: **Local Government Officials and Their Independent Auditors**

FROM: **Sharon Edmundson, Director, Fiscal Management**

SUBJECT: **GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets***

DATE: **August 23, 2010**

The purpose of this memo is to provide guidance on GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which details when intangible assets should be considered capital assets for financial reporting purposes. This Statement is effective for financial statements for periods beginning after June 15, 2009, therefore fiscal year ended June 30, 2010 for most North Carolina local governments. Common types of intangible assets include right of way easements, other easements, land use rights, licenses and permits, water rights, and computer software. It is important to note that government powers created through statute or inherent to the nature of government, such as the power to levy a tax, are not intangible assets as defined by GASB Statement No. 51.

Overview

Intangible assets include assets such as easements, water rights, timber rights, patents, trademarks, and computer software. Paragraph 19 of GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, states capital assets include intangible assets that are used in operations and have initial useful lives that extend beyond a single reporting period. Paragraph 21 of GASB Statement No. 34 explains that capital assets should be depreciated (or amortized) over their estimated useful lives and those inexhaustible capital assets such as land and land improvements should not be depreciated (or amortized.) Paragraph 2 of GASB Statement No. 51 amends GASB Statement No. 34 and defines an intangible asset as possessing all of the following characteristics:

- "Lack of physical substance. An asset may be contained in or on an item with physical substance, for example, a compact disc in the case of computer software. An asset also may be closely associated with another item that has physical substance, for example, the underlying land in the case of a right-of-way easement. These modes of containment and associated items should not be considered when determining whether or not an asset lacks physical substance.

- Nonfinancial nature. In the context of this Statement, an asset with a nonfinancial nature is one that is not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods or services.
- Initial useful life extending beyond a single reporting period."

Intangible assets that meet at least one of the following exemptions are excluded from the provisions of the Statement:

- Assets acquired or created primarily for the purpose of directly obtaining income or profit,
- Assets resulting from capital lease transactions reported by lessees, or
- Goodwill created through the combination of a government and another entity. (Paragraph 3, GASB Statement No. 51)

Identifiable intangible assets that meet the above characteristics and are not exempt should be classified as capital assets and recognized as such on the financial statements. As capital assets, intangibles are subject to all existing guidance regarding capital assets. It is important to remember that they are reported as expenditures in the fund statements of governmental funds and not as assets. Intangible assets are identifiable when either of the following conditions is met:

- The asset is capable of being separated or divided from the government and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability, or
- The asset arises from contractual or other legal rights.

Internally Generated Intangible Assets

Intangible assets that are created or produced by the government or an entity contracted by the government would be considered internally generated. Assets acquired from a third party, but require more than minimal incremental efforts on the part of the government to begin achieving their expected level of service capacity, also are considered internally generated. Outlays that are incurred in the generation of internally generated intangible assets should be expensed until certain criteria are met. GASB Statement No. 51 paragraph 8, states that all three of the following requirements must occur before capitalization begins.

- Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the intangible asset upon the completion of the project,
- Demonstration of the technical or technological feasibility for completing the project so the intangible asset will provide its expected service capacity, and
- Demonstration of the current intention, ability, and presence of effort to complete or, in the case of multiyear project, continued development of the intangible asset.
- Examples from the 2009 Comprehensive Implementation Guide (CIG) Question Z.51.10 are:
    - Budgetary commitments for funding the project

- Reference to the project in strategic planning documents
- Commitments with external parties to assist in the creation of the intangible asset
- Internal assignments or the hiring of specific personnel to work on the project
- Efforts made to secure the government's legal rights to the results of the project

Amortization

Paragraph 17 of Statement No. 51 states "an intangible asset should be considered to have an indefinite life if there are no legal, contractual, regulatory, technological or other factors that limit the useful life of an asset" (i.e., a permanent right-of-way easement). Intangible assets determined to have an indefinite life should not be amortized. However, if changes occur such that an asset no longer has an indefinite useful life, the asset should be evaluated for impairment. After any adjustment for impairment is recorded, the remaining value should be amortized over the remaining useful life of the asset. Changes in duration of use, change in term or status of contract, evidence of obsolescence, enactment or approval of laws or regulations or other changes in environmental factors, and development stoppage are indicators of impairment in addition to physical damage. Refer to paragraph 9 of GASB Statement No. 42 for more information in regards to accounting for impairments.

Retroactive Reporting

Paragraph 20 of GASB Statement No. 51 states accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by restating financial statements, if practical. Governments should determine actual historical cost if records are sufficient. A lack of records may make determining the historical cost impractical. In that case, the estimated historical cost should be reported for assets acquired after fiscal year ended June 30, 1980. Retroactive reporting is required for governments classified as Phase 1 or Phase 2 under GASB Statement No. 34. Governments classified as Phase 3 under GASB Statement No. 34 are not required to report retroactively.

Retroactive reporting is not required for intangible assets determined to have indefinite life as of the effective date of GASB Statement No. 51, but it is allowed. If a government can determine the cost of some intangible assets considered having an indefinite life but not all, that government can retroactively report only those assets for which cost information is available. Governments can apply the same rule to internally generated intangible assets. If recognition criteria can be applied to internally generated software to determine cost on some but not all assets, the government can choose to only retroactively report those assets for which cost can be determined.

The rules for retroactive reporting are slightly different for amortization provisions. Generally amortization provisions should be applied retroactively. If an asset is determined to have an indefinite life and prior to the implementation of GASB 51 the value of that asset was being amortized, the financial records should be adjusted to reflect no amortization of that asset, and beginning balances restated. On the other hand if during implementation of Statement No. 51 an intangible asset once considered to have an indefinite life now has a finite life, the amortization provisions should not be reported retroactively. The amortization should begin in the year of implementation. In this situation, the asset will have no beginning accumulated amortization even though the intangible asset was acquired in a previous year. Essentially, the unit of government must reevaluate each intangible asset that was accounted for on its books before the implementation of GASB Statement No. 51.

Note Disclosures

According to paragraph 5 of GASB Statement No. 51, all intangible assets subject to this Statement should be classified as capital assets and disclosed as such. Intangible assets should be grouped with those of a similar nature and usage (i.e., right-of-way easements, water rights, and software.) Also, if the unit is required or elected to apply GASB Statement No. 51 retroactively, the disclosure for the accounting principles used for capital assets should include the policy applied by the unit of government for reporting the intangible assets to the extent that the appropriate historical cost can be determined.

Internally Generated Computer Software

Statement No. 51 recognizes computer software as internally generated if it is purchased or licensed by the government and modified with more than minimal incremental effort before putting into service. Websites also are considered in this group of assets, however keep in mind that there is a high hurdle here to exceed before capitalization is required. As with all other internally generated intangible assets, computer software should be expensed until the requirements to capitalize are met. However, paragraph 11 of GASB Statement 51 states that requirements for computer software are considered to be met when the following occur:

- The activities noted in the preliminary project stage are completed, and
- Management implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multiyear project, the software project.

Internally generated computer software is grouped into three stages: preliminary project, application/development, and post-implementation. Only during the application/development stage should outlays incurred be capitalized. Outlays associated with the preliminary and post implementation stages should be expensed as incurred.

Preliminary stage activities include: selecting a vendor, selecting a consultant to assist in development or installation, final selection of alternatives for development, making strategic decisions to allocated resources at a point in time, determining the performance requirements for the project, and determining the existence of needed technology. Training employees involved with the development of internally generated software, if the training does not contribute to putting the software in use, should also be expensed as incurred and not included in the application development stage.

Included in the application/development stage are activities such as coding, software configuration, testing, installation to hardware, and data conversion. Tasks considered to be data conversion include purging or cleansing of existing data and reconciliation from the legacy system to the new system. Data conversion should only be included in the application development stage to the extent that it is necessary to make software operational. The 2009 Comprehensive Implementation Guide references a human resource software system as an example of when data conversion is needed for operational purposes. In a human resource system, payroll transactions are dependent on the transfer of information such as direct deposit information and tax deductions in order to pay employees.

If the data conversion is deemed unnecessary for operation or more informational than essential, it should be included in the post implementation stage. The same rule applies for data conversion activities associated with computer software not internally generated. Internal modification of existing software to make it able to interface with new software should be capitalized if it increases the functionality/efficiency or extends its useful life.

Post implementation stage activities include software maintenance and application training. Please note maintenance activities that do not improve efficiency/functionality or extend useful life would be considered post implementation and should be expensed as incurred. The same rules apply for training activities when computer software is not considered internally generated. Outlays from business process reengineering activities that result during the development should not be considered a cost of development, but should be expensed. Refer to paragraph 10 of GASB Statement No. 51 for a detailed description of all three stages.

Commercially available computer software that is purchased or licensed by the government and placed into operation without modification, or requiring minimal incremental effort to modify is not considered 'internally generated.' However, it will still meet the description of an intangible asset in paragraph 2 of GASB Statement No. 51. Consider a unit of government that acquires computer software through a five year licensing agreement requiring annual payments for the right to use. The unit of government should report the software as an intangible asset and record a long-term liability for the required annual payments. The government should not consider this software as internally generated. If the licensing agreement includes several components each component should be evaluated for capitalization. Similarly, an enterprise resource planning system with multiple modules, including procurement, human resources, and financial reporting, should have each module evaluated individually as to its stage in development. Maintenance agreements result in external modifications of the software that increase its functionality or improve the efficiency of the software should be capitalized as intangibles. Otherwise, maintenance agreements should be expensed. Theoretically the unit should split its maintenance agreement outlays into these two subsets. However, materiality should be considered in this decision – the unit may as a matter of policy expense all maintenance agreements that are not specified to increase functionality and/or improve efficiency (2009 CIG Z.51.23).

Water Rights

Water rights are not excluded from the provisions of GASB Statement No. 51 even if income or profit is generated through the sale of water. Question Z.51.5 in the 2009 Comprehensive Implementation Guide states that water rights used in operations are not themselves directly generating income or profit. Income and profit are indirect results of ownership of the rights, therefore making water rights used in operations of water system an intangible asset. Water rights acquired for the purpose of trading those rights to obtain income are not intangible assets.

Right of Way Easements

Right of way easements are generally considered to be recordable intangible assets. A separate asset for the right-of-way easement should be reported at fair value at the time of acquisition in accordance with GASB Statement 34, paragraph 18. Determining the fair value is a challenge for right of way easements. The fair value of any asset is the amount at which the asset could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. In the case of right-of-way easements for roads, however, generally the only willing buyer is the government. The fair value can then be estimated to be the outlay the government would have incurred to acquire the easement in an exchange transaction. There also may be other reasonable methods for determining the fair value of a donated right-of-way easement. However, it is not appropriate to arbitrarily assign a nominal value to a donated easement.

If you have any questions, please call Alexia Forte at 919-807-2393 or via email at Alexiaforte@nctreasurer.com