GASB Update

Effective for 2010 Fiscal Year

GASB Statement 51, *Accounting and Financial Reporting for Intangible Assets*

GASB Statement 53, *Accounting and Financial Reporting for Derivative Instruments*

GASB 51 – Intangible Assets
Background

- First addressed in GASB 34 (para. 19), which included intangible assets in the description of items that should be considered capital assets.
  - Created questions as to whether intangible assets should be accounted for using the guidance of GASB 34 or the existing authoritative guidance – *APB 17, Intangible Assets.*
- Also, some governments were following AICPA SOP 98-1 (only applied to nongovernmental entities).
- GASB 51 was issued in June 2007 to reduce inconsistencies in financial reporting.

GASB 51 – Intangible Assets

- Provides needed guidance on how to identify, account for, and report intangible assets.
- GASB 51 defines an intangible asset as an asset that possesses <u>all</u> of the following characteristics:
  - Lack of physical substance
  - Nonfinancial in nature
  - A useful life extending beyond a single reporting period
- <u>Common Examples</u> – computer software, easements, land use rights, patents, copyrights, and trademarks.

GASB 51 (cont.)

- Scope Exceptions – The following 3 items are **expressly excluded** from being classified as intangible assets, even though they meet the criteria just described.
  - Items acquired primarily for the purposes of obtaining income or profit, rather than for use in operations
  - Assets obtained though capital leases
  - Goodwill acquired through a combination with another entity

GASB 51 (cont.)

- Fundamental principle - Intangible assets are just a subcategory of capital assets.
  - All GAAP requirements applicable to capital assets should be applied to intangible assets
- In addition, GASB 51 provides specialized guidance to specifically address the unique nature of intangible assets, including:
  - A specified-conditions approach to recognizing intangible assets that are internally generated (patents)
  - Guidance on recognizing internally generated computer software
  - Specific guidance on amortization of intangible assets

Internally Generated Intangible Assets

- When developing GASB 51, the GASB compared the nature of internally generated intangible assets (IGIA) to its physical counterpart, CIP capital assets.
- The GASB concluded that there is a higher degree of research activity related to project alternatives associated with IGIA in development than with tangible CIP capital assets.
  - Also, the GASB believes the risk of abandoning a project prior to completion, for reasons such as technological infeasibility or a change in priorities of management is greater for IGIA.
- Given these considerations, the GASB concluded that recognition guidance specific to IGIA should be provided.

Internally Generated Intangible Assets

- GASB 51 gives special measurement/recognition guidance for intangible assets that are internally generated and will be used in operations.
- An intangible asset is considered internally generated if the asset is either:
  - Created or produced by the government or an entity contracted by the government; or
  - Acquired from a third party but require "<u>more than minimal incremental effort</u>" to achieve expected service capacity (e.g., "off-the-shelf" software)

Internally Generated Intangible Assets

- Common types of intangible assets held by governments that may be internally generated include:
  - Computer software
  - Patents
  - Trademarks
  - Copyrights

Internally Generated Intangible Assets

- Capitalization of internally generated intangible assets can only occur after ALL of the following conditions have been met.
  a) The specific objective of the project has been determined
  b) The nature of the service capacity to be provided has been determined
  c) The feasibility of successfully completing the project has been demonstrated
  d) The government has *demonstrated* that it 1) intends, 2) is able, and 3) is making an effort to complete or continue development of the project (see Implementation Guide)
- Outlays incurred prior to meeting these criteria should be expensed as incurred and should not be capitalized in a future period (i.e., no “recycling” of expenses)

Internally Generated Intangible Assets

- GASB Implementation Guide (Z51.10) – Examples of evidence indicating that item "d" of the recognition criteria for IGIA has been met include the following:
  - Committing resources for the project in budgets.
  - Discussing the project in strategic planning documents
  - Committing with external parties to assist in the creation of the intangible asset
  - Seeking to secure the government's legal rights to the results of the project (e.g., securing trademark rights)
- The Guide also clarifies that interest capitalization requirements of FASB 34 and 62 also apply to internally generated intangible assets of business-type activities and enterprise funds (Z51.11).

Internally Generated Computer Software

- Computer software is a common type of intangible asset that is often internally generated.
- GASB 51 provides specific guidance on applying the IGIA specified-conditions approach for internally generated computer software (IGCS).
- Guidance based on development stages similar to AICPA SOP 98-1

Internally Generated Computer Software

- Computer software should be considered internally generated if it is either:
  - Developed in-house by the government's personnel or by a contractor on their behalf; or
  - Commercially available software that is purchased or licensed by the government and <u>modified using more than minimal incremental effort</u> before being put in operation

Internally Generated Computer Software

- Any of the following activities would satisfy the "*modified using more than minimal incremental effort*" criterion:
  - Changing code or fields
  - Adding special reporting capabilities

Internally Generated Computer Software

- Activities associated with developing IGCS should be categorized in one of three development stages:
  - Preliminary Project Stage
  - Application Development Stage
  - Post-Implementation/Operation Stage

Internally Generated Computer Software

- The *<u>preliminary project stage</u>* includes the following:
  - Conceptual formulation
  - Evaluation of alternatives
  - Determination of existence of needed technology
  - Final selection of alternatives for development
- All outlays incurred during this stage should be <u>expensed</u> as incurred.

Internally Generated Computer Software

- The <u>*application development stage*</u> includes the following:
  - Design of the chosen path
  - Coding
  - Installation to hardware
  - Testing and parallel processing
- All outlays incurred during this stage should be <u>capitalized</u> provided the following conditions are met.

Internally Generated Computer Software

1) The outlays were incurred subsequent to the completion of the preliminary project stage, and
2) Management authorizes and commits to funding (either implicitly or explicitly), at least through the current period.
   - For commercially available software that needs to be modified, both of these conditions generally are met at the time a government makes the commitment to purchase or license the software.

- Cease capitalizing when software is substantially complete and operational (i.e., ready for use)

Internally Generated Computer Software

- The *post-implementation/operation stage* includes the following:
  - Application training
  - Software maintenance
- All outlays incurred during this stage should be expensed.

Internally Generated Computer Software

- The activities within the three stages of development may occur in a different sequence.
- GASB 51 stresses that it is the nature of the activities done in the application/development stage that require capitalization, not their timing.
  - Outlays associated with application training activities that occur during application development stage should be expensed.
- ERP systems with multiple modules – apply guidance separately to each module (not system as whole)

Internally Generated Computer Software

- GASB 51 includes additional guidance on <u>data conversion activities</u>.
- Data conversion activities may include:
  - Purging/cleansing of existing data
  - Conversion of data from legacy system to new system
  - Reconciliation of data from legacy system and data in new system
- Data conversion should be considered activity of the application development stage <u>only if necessary to make software operational</u> – otherwise post-implementation/operation stage.
- Statement 51 provision differs from SOP 98-1.

Internally Generated Computer Software

- The rules that generally govern when improvements to capital assets should be capitalized also apply to software.
- Specifically, an improvement to existing software must do at least one of the following to qualify for capitalization:
  - Increase the software's functionality,
  - Increase the software's efficiency, or
  - Extend the software's estimated useful life.
- If modification does not result in one of the above, associated outlays should be expensed as maintenance.

Purchased/Licensed Computer Software

- Not internally generated – placed into operation with minimal modification.
- For software acquired through a multi-year licensing agreement:
  - Long-term liability representing agency's obligation to make annual payments under the contract should also be reported
  - FASB 13 does not apply to licensing agreements

Amortization

- If the life of an intangible asset is limited by contract or regulation, the asset should be amortized over the life of the contract or associated legal provisions.
- Sometimes the associated contract will provide a renewal option:
  - If so, the useful life of the intangible asset would include the renewal period if there is evidence that:
    1) Renewal will be sought and will be able to be achieved; and
    2) Any anticipated outlays related to renewal are nominal.

Amortization

- **Example** – A government entered into a contract to purchase water rights for 30 years in exchange for a cash payment of $100 million. The contract contains a 10-year renewal option for $30 million.
- In this case, the renewal option, does **NOT** represent an extension of the original contact but instead, represents the opportunity to acquire a new asset, 10-year water rights.
  - Therefore, the renewal period should not be considered.

Amortization

- An intangible asset should be considered to have an indefinite useful life if there are no legal, contractual, regulatory, technological, or other factors that limit the life of the asset.
  - Example - Easement purchased as part of a highway system.
  - Intangible assets with indefinite useful lives should **NOT** be amortized.

Impairment Accounting

- Like all capital assets, intangible assets are subject to impairment.
- Statement 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,* lists 5 specific indicators of impairment.
  - *GASB 51 amended GASB 42 by adding "development stoppage" as a sixth indicator of impairment.*
  - Intangible assets impaired by development stoppage should be reported at the <u>lower of carrying value or fair value</u>, assuming the stoppage was considered to be permanent.

Note Disclosures

- GASB 51 does not require any additional note disclosures.
- Intangible assets should be incorporated into the existing capital asset note disclosures.
  - Implementation Guide (Z.51.29) - If the types of intangible assets reported by a government differ in nature and usage, then they should **NOT** be reported collectively as a single major class of capital assets (e.g., intangible assets).
    - Land use rights (water, timber, mineral rights)

Retroactive Reporting

- Retroactive reporting is required for intangible assets, **EXCEPT** retroactive reporting is not required for:
  1) Internally generated intangible assets, including those in development as of the effective date.
  2) Intangible asset with an indefinite useful life as of the effective date.

- Prior to GASB 51, intangible assets with an indefinite useful life were amortized over a 40-year period in accordance with APB Opinion # 17.
  – Any accumulated amortization on such assets at transition should be removed.

Retroactive Reporting

Note

- GASB 51 should be applied to modifications of computer software regardless of whether the original software being modified was reported as an asset in the financial statements.

OSC Guidance

- Issued “Intangible Assets Policy” in May 2009.
  - Includes following capitalization thresholds:
    - $1 million – Internally generated computer software (application development costs only)
    - $100,000 – All other intangible assets
- Revised the “Depreciation Policy” and statewide chart of accounts in March 2010
  - Added useful life ranges for intangible assets
  - Added new accounts for non-depreciable and depreciable intangible assets
- Updated year-end CAFR package for GASB 51
  - CAFR Worksheets 201 and 210

OSC Guidance – New Accounts

- New Nondepreciable Accounts:
  - Computer Software in Development
  - Patents in Development
  - Permanent Easements (renamed existing account)
- New Depreciable Accounts
  - Computer Software
  - Patents
  - Other Intangible Assets (renamed existing account)
  - Related Accumulated Amortization Accounts

GASB 51 – Implementation Issues

- Determine which intangible assets will need to be reported retroactively.
  - Retroactive reporting is not required for internally generated computer software and patents; intangibles with an indefinite useful life.
- Must have a cost accounting system that can segregate IGCS projects by development stage.
  - Only application development costs should be capitalized.
- Assign estimated useful lives to intangible assets that are subject to amortization.

GASB 53 – Derivatives Background

- GASB Technical Bulletin 2003-1 was issued to provide clarifying guidance on derivative disclosures.
  - Was issued as interim guidance until a separate pronouncement was issued on derivatives.
- 2006 Preliminary Views
- 2007 Exposure Draft
- 2008 GASB 53
  - Addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by SLGs

What are Derivatives?

- Derivatives are complex financial arrangements used by governments to manage specific risks or to make investments.
- GASB 53 defines derivatives as having all of the following:
  - Settlement factors (one or more reference rates and one or more notional amounts, or both)
  - Leverage (no or small initial investment)
  - Net settlement (require or permit net settlement)
- Essentially the same definition for derivatives as Technical Bulletin 2003-1.

Common Types of Derivatives

- Interest rate swaps
- Interest rate locks
- Options (caps, floors, and collars)
- Swaptions
- Forward contracts
- Futures contracts

GASB 53 – The Basics

- GASB 53 requires governments to report most of their derivatives at fair value on their statement of net assets.
  - Depending on their value, derivatives may be reported as assets or liabilities (Note: most swaps were liabilities at June 30, 2009).
- The presumed fair value of a derivative is its market price.
  - In the absence of an active market, the discounted value of expected cash flows may be used.
  - Formula-based and mathematical methods are also acceptable (e.g., matrix pricing).

GASB 53 – The Basics

Note

- For many derivatives, historical costs are <u>zero</u> because their terms are developed so that they may be entered into without a payment being received or made.

GASB 53 – The Basics

- Changes in fair values of investment derivative instruments should be reported as investment income.
- Investment derivatives are derivatives that are entered into by the government primarily for the purpose of obtaining income or profit, or derivatives that the government determines are ineffective as hedges.

GASB 53 – The Basics

- Changes in fair values of hedging derivative instruments should be deferred until a termination event occurs.
  - Example: The hedge is determined to be ineffective or the hedge asset or liability is sold or retired.
- Hedging derivatives are derivatives that significantly reduce an identified financial risk by substantially offsetting changes in cash flows or fair values associated with items not reported at fair value.

GASB 53 – The Basics

- Hedging derivative instruments must meet annual effectiveness tests.
  - Once a hedging derivative is determined to be ineffective, any related deferral amounts should be closed to investment income.
  - Exception – Refundings
- Governments are allowed to use two types of approaches for determining effectiveness.
  - Consistent critical terms method (simplest to apply)
    - Terms between the hedgeable item and hedging derivative are consistent.
  - Quantitative methods (3 are provided)

Consistent Critical Terms Method

	Hedged Debt	Hedging Derivative
Principal/notional	$1,000	$1,000
Term	10 years	10 years
Payments, every	6 months	6 months
Variable payment	SIFMA	SIFMA

GASB 53 – The Basics

- First Reporting Period Evaluation
  - If a potential hedging derivative is first evaluated using the consistent critical terms method and is found to be ineffective:
    - At least one quantitative method should also be applied before concluding that it is ineffective.
- Evaluation in Subsequent Reporting Periods
  - All potential hedging derivatives that were determined to be effective in the prior reporting period should be re-evaluated at the end of the current period using the same method that was previously applied.
    - If found to be no longer effective, other methods may, but are not required to, be applied before concluding that the derivative is ineffective.

GASB 53 – Example

	Dr	Cr
Year 1 – Effective		
Deferred outflow	100	
Derivative instrument – swap		100
(To record change in fair value)		
Year 2 – Effective		
Deferred outflow	25	
Derivative instrument – swap		25
(To record change in fair value)		
Year 3 – Ineffective		
Investment revenue	125	
Deferred outflow		125
(To record previously recorded deferred charges as revenue since swap no longer effective)		
Derivative instrument – swap	15	
Investment revenue		15
(To record change in fair value)		

GASB 53 – Note Disclosures

- The note disclosure requirements of GASB 53 reflect the Statement's distinction between derivatives that function as investments and those used for hedging.
  – Like other investments, derivatives that function as investments generally must provide the disclosures required by GASB 40.
  – For derivatives used as hedges, GASB 53 has essentially incorporated the disclosure requirements of Technical Bulletin 2003-1.
  – A note disclosure that includes summary information about a government's derivative instruments is also required.

GASB 53 – Implementation Issues

- Determine if beginning fund equity should be restated for derivatives existing prior to July 1, 2009.
  - If a potential hedging derivative is found to be ineffective at June 30, 2010 and 2009, it will need to be reported retroactively as if it were an investment derivative.
- GASB 53 provides guidance on acceptable methods for determining fair value.
  - Fair values are typically obtained from counterparties.
  - Agencies are still responsible for making sure the fair value calculations comply with GASB 53.
  - For future derivatives, may want to require counterparties to provide fair values, at least annually, in accordance with GASB 53.

GASB 53 – Implementation Issues

OSC will update the Chart of Accounts for GASB 53

- New Asset Accounts (current/noncurrent):
  - Investment Derivatives
  - Hedging Derivatives
  - Deferred Outflow of Resources
- New Liability Accounts (current/noncurrent):
  - Investment Derivatives Liability
  - Hedging Derivatives Liability
  - Deferred Inflow of Resources

GASB 53 – Additional Resources

- A plain language summary of GASB 53 is available for download on the GASB website (www.GASB.org).
- GASB 53 Implementation Guide was issued in February 2009 (available for purchase).

Other Pronouncements

- GASB 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans.*
- GASB 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies.*
- These Statements are not expected to impact universities.

Questions?

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