RIVERSIDE COUNTY
OFFICE OF THE
AUDITOR-CONTROLLER

County Administrative Center
4080 Lemon Street, 11th Floor
P.O. Box 1326
Riverside, CA 92502-1326
(951) 955-3800
Fax (951) 955-3802

COUNTY OF RIVERSIDE
AUDITOR-CONTROLLER

Robert E. Byrd, CGFM
AUDITOR-CONTROLLER

Bruce Kincaid, MBA
ASSISTANT
AUDITOR-CONTROLLER

GASB Statement No. 51 Summary

Accounting and Financial Reporting for Intangible Assets

Since the issuance of Governmental Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements – and Management's Discussion and analysis – for State and Local Governments, questions have been raised regarding the inclusion of intangible assets as capital assets for accounting and financial reporting purposes. Inconsistencies in the accounting and financial reporting for intangible assets, particularly in the areas of recognition, initial measurement, and amortization, have occurred in practice due to the absence of sufficiently specific authoritative guidance that addresses these questions. The objective of GASB statement 51 is to establish accounting and financial reporting requirements for intangible assets to reduce these inconsistencies, thereby enhancing the comparability of the accounting and financial reporting of such assets among state and local governments.

Effective Date

Statement No. 51 is effective for fiscal periods ending June 30, 2010. Retroactive reporting is required for intangible assets except for those that would be considered to have indefinite useful lives as of the effective date of this statement and those that would be considered internally generated. If determining the actual historical cost of these intangible assets is not practical due to the lack of sufficient records, the County should report the estimated historical cost for these intangible assets that were acquired in fiscal years ending after June 30, 1980.

What are Intangible Assets?

An intangible asset is an asset that possesses all of the following characteristics:

a. 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.

b. Non financial nature.

   An asset 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.

c. Initial useful life extending beyond a single reporting period.

Common Types of Intangible Assets

a. Right-of -way
b. Easements
c. Patents, copyrights, trademarks
d. Land use rights (i.e.; water, timber)
e. Licenses and permits
f. Computer software
   - Purchased or licensed
   - Internally generated

Basic Intangible Assets Guidance

All intangible assets subject to Statement No. 51 should be classified as capital assets. All existing authoritative guidance related to the accounting and financial reporting for capital assets, including the areas of recognition, measurement, depreciation (termed *amortization* for intangible assets), impairment, presentation, and disclosures should be applied to intangible assets. Since intangible assets are considered capital assets, they are not reported as assets in modified accrual financial statements.

Exceptions

The provisions of statement No. 51 apply to all intangible assets except for the following:

a. Intangible assets acquired or created primarily for the purpose of directly obtaining income or profit.
b. Assets resulting from capital lease transactions reported by lessees.
c. Good will created through the combination of a government and another entity.

Recognition Criteria

An intangible asset should be recognized in the Government-wide statement of net assets and the Proprietary Fund Statement of Net Assets only if it is identifiable. An intangible asset is considered identifiable when either of the following conditions is met:

a. The asset is separable, that is, 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.
b. The asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

For example, land use rights such as water rights, timber rights, mineral rights, easements, and right-of-ways associated with property already owned by the County are considered a bundle of rights. The value of the individual rights in the bundle of rights of property ownership should remain aggregated and reported as a tangible capital asset upon implementation of GASB No. 51. Because these land use rights are considered part of the tangible asset (the associated property) and the property is reported at historical cost, the reported value of the property already includes consideration for all rights associated with ownership of that asset. Therefore, the tangible capital asset should not be increased upon implementation of GASB No. 51 to reflect the current value of land rights that could be separated and transferred. In contrast, land use rights that were acquired in a transaction that did not involve acquiring the underlying property should be reported as an intangible asset subject to the transaction provisions of GASB No. 51 if they meet the description of an intangible asset.

Internally Generated Intangible Assets

Intangible assets are considered internally generated if they are created or produced by the government or an entity contracted by the government, or if they are acquired from a third party but require more than minimal incremental effort on the part of the government to begin to achieve their expected level of service capacity.

Outlays incurred related to the development of an internally generated intangible asset that is identifiable should be capitalized <u>only</u> upon the occurrence of <u>all</u> of the following:

a. 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 completion of the project.
b. Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity.
c. Demonstration of the current intention, ability, and presence of effort to complete or, in the case of a multiyear project, continue development of the intangible asset.

Only outlays incurred subsequent to meeting the above criteria should be capitalized. Outlays incurred prior to meeting those criteria should be expensed as incurred.

Evidence that the above criteria have been met may include the following:

- Budgetary commitments for funding the project.
- Reference to the project in strategic planning documents.
- Commitments with external parties to assist in the Intangible Asset's creation.
- Internal assignments or the hiring of specific personnel to work on the project.
- Efforts made to secure the County's legal rights to the results of the project.

Internally Generated Computer Software

Computer software is a common type of intangible asset that is often internally generated. Computer software should be considered internally generated if it is developed in-house by the government's personnel or by a third-party contractor on behalf of the government. Commercially available software that is purchased or licensed by the government and modified using more than minimal incremental effort before being put into operation also should be considered internally generated for the purpose of this Statement. For example, licensed financial accounting software that the government modifies to add special reporting capabilities would be considered internally generated.

The activities involved in developing and installing internally generated computer software can be grouped into the following stages:

a. *Preliminary Project Stage.* Activities in this stage include the conceptual formulation and evaluation of alternatives, the determination of the existence of needed technology, and the final selection of alternatives for the development of the software.
b. *Application Development Stage.* Activities in this stage include the design of the chosen path, including software configuration and software interfaces, coding, installation to hardware, and testing, including the parallel processing phase.
c. *Post-Implementation/Operation Stage.* Activities in this stage include application training and software maintenance.

Data conversion should be considered an activity of the application development stage <u>only</u> to the extent it is determined to be necessary to make the computer software operational, that is, in condition for use. Otherwise, data conversion should be considered an activity of the post-implementation/operation stage.

For internally generated software, the above criteria should be considered to be met only when both of the following occur:

a. The activities noted in the preliminary project stage are completed.
b. Management with the relevant authority (Board of Supervisors) implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multiyear project, the software project.

Accordingly, outlays associated with activities in the preliminary project stage should be expensed as incurred. For commercially available software that will be modified to the point that it is considered internally generated, (a) and (b) above generally could be considered to have occurred upon the government's commitment to purchase or license the computer software.

Once the criteria in (a) and (b) in the paragraph immediately above have been met, outlays related to activities in the application development stage should be capitalized. Capitalization of such outlays should cease no later than the point at which the computer software is substantially complete and operational.

Outlays associated with activities in the *post-implementation/operation* stage should be expensed as incurred.

The activities within the application development stage may occur in a sequence different from that shown above. The recognition guidance for outlays associated with the development of internally generated computer software set forth above should be applied based on the nature of the activity, not the timing of its occurrence. For example, outlays associated with application training activities that occur during the application development stage should be expensed as incurred.

Modification of internally generated software that is already in operation

Outlays associated with an internally generated modification of computer software that is already in operation should be capitalized if one of the following criteria is met:

a. An increase in the functionality of the computer software, that is, the computer software is able to perform tasks that it was previously incapable of performing.
b. An increase in the efficiency of the computer software, that is, an increase in the level of service provided by the computer software without the ability to perform additional tasks.
c. An extension of the estimated useful life of the software.

If the modification does not result in any of the above outcomes, the modification should be considered maintenance, and the associated outlays should be expensed as incurred.

Impairment

In addition to impairment indicators described in GASB Statement No. 42, a common indicator of impairment for internally generated intangible assets is development stoppage, such as stoppage of development of computer software due to a change in the priorities of management. Internally generated intangible assets impaired from development stoppage should be reported at the lower of carrying value or fair value.

Capitalization Threshold

The threshold for capitalizing cost that occur in the *Application Development Stage* is greater than or equal to $150,000.

Illustration

Example – Recognition of Internally Generated Computer Software

Assumptions

In the July 2012 the City Department of Tax Assessment identified the need for new property tax assessment and billing software. Upon identification of this need, the city assembled a project task force composed of staff from various departments. From July through October 2012, the task force performed numerous tasks related to the project including the following;

- Determining the performance requirements of the new software through interviews with operators of the software and users of information to be provided by the software.
- Determining the system requirements for the new software, including assessing the compatibility of existing hardware and other interfaced software, such as the city's general ledger system.
- Assessing in-house information technology resources to determine whether the software should be developed internally or if commercial software packages should be explored.
- Issuing a request for proposals for commercial software packages and installation services and conducting interviews with proposing vendors.

Based on the recommendation of the task force, the city awarded a contract in the amount of $15 million to Madlin Software Corporation to acquire a perpetual license to use its property tax assessment software as modified to meet the city's needs. As part of the contract, Madlin would be responsible for installation and modification of the software, while three city employees would be dedicated to the project full time until its completion. The city included a $16 million appropriation in its 2013 fund budget to cover the cost of the software.

Installation of the software occurred from January through July 2013. Testing of the software and any resulting modifications were completed in October 2013, at which point the software was considered to be substantially complete and operational. Entry of tax year 2014 assessment information and applicable tax rates and training of software users and operators occurred from October through December 2013 so that the software could be used to produce the city's 2014 tax bills. The city's fiscal year-end is December 31.

The city determined that the aggregate outlays of the software project were $17.5 million, composed of the following: (Note 1)

- Outlays associated with the task force activities from July through November 2012: $1.5 million.
- Outlays for commercial software and installation services: $14.6 million.
- Outlays for payroll and related costs associated with employees involved in installation and testing of software: $500 thousand.
- Outlays for training software users and operators: $300 thousand.
- Outlays for payroll and related costs associated with employees involved in entry of new tax year (2014) assessment information and applicable tax rates: $250 thousand.

Preliminary Project Stage:

The activities of the task force should be considered preliminary project stage activities, and the related outlays should be expensed/expended as incurred. Therefore, for the fiscal year ended December 31, 2012, the city should record the outlays associated with the task force activities of $1.5 million as an expense in its government-wide statement of activities and an expenditure in its general fund statement of revenues, expenditures, and changes in fund balance.

Application Development Stage:

The acquisition of the license to use the commercially available software and the installation and testing activities occurring in 2013 should be considered application development stage activities. The related outlays of $15.1 million should be capitalized in the 2013 government-wide statement of net assets as the preliminary project stage had been completed in November 2012, and the city included an appropriation to fund the software development in its 2013 general fund budget, providing evidence of its commitment to complete the project. These outlays would be recorded as an expenditure in the 2013 general fund statement of revenues, expenditures, and changes in fund balance.

Post implementation/Operation Stage:

The training activities occurring in 2013 should be considered post implementation/operation stage activities and expensed/expended as incurred. Additionally, the outlays associated with the data entry activities also should be expensed/expended because they related to the entry of new tax information. Therefore, for the fiscal year ended December 31, 2013, the city should record the outlays associated with the training and data entry activities of $550 thousand as an expense in its government-wide statement of activities and as an expenditure in its general fund statement of revenues, expenditures, and changes in fund balance.

(Note 1)

The accumulation of project outlays by activity has been provided to facilitate this example. For accounting and financial reporting purposes, only the accumulation of project outlays that will be capitalized would be required.