Intangibles: Governments' Forgotten Capital Assets

By: **Dwayne N. McSwain**, Terry K. Patton, and Daniel C. Benco

Abstract

Prior to implementing Governmental Accounting Standards Board (GASB) Statement 34, *Basic Financial Statements -- and Management's Discussion and Analysis -- for State and local Governments*, governments typically reported few, if any, of their intangible assets in their financial statements. Some governments may have recognized easements for roads that they purchased as capital assets, but they typically did not recognize such easements if they were donated to the government (for example, by a developer). Since GASB issued Statement 34, which specifically refers to easements and intangible assets that are used in operations as capital assets, preparers of governmental financial reports have asked a number of questions. These questions include the following: Should land under roads be reported if the land is not owned, but easement rights exist? Does it make a difference if the easement was donated instead of purchased? Should water rights be reported? Should internally generated computer software be reported as an intangible asset, or written off? Should other internally generated intangible assets, such as patents and trademarks, be reported? Should any, or all, intangible assets be amortized? GASB Statement 51, Accounting and Financial Reporting for Intangible Assets, which was issued in June 2007, provides guidance for these questions and many more by clarifying the financial reporting requirements for intangible assets established in Statement 34.

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Intangibles: Governments' Forgotten Capital Assets

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Prior to implementing Governmental Accounting Standards Board (GASB) Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, governments typically reported few, if any, of their intangible assets in their financial statements. Some governments may have recognized easements for roads that they purchased as capital assets, but they typically did not recognize such easements if they were donated to the government (for example, by a developer). Since GASB issued Statement 34, which specifically refers to easements and intangible assets that are used in operations as capital assets, preparers of governmental financial reports have asked a number of questions. These questions include the following:

- Should land under roads be reported if the land is not owned, but easement rights exist? Does it make a difference if the easement was donated instead of purchased?
- Should water rights be reported?
- Should internally generated computer software be reported as an intangible asset, or written off? Should other internally generated intangible assets, such as patents and trademarks, be reported?
- Should any, or all, intangible assets be amortized?

GASB Statement 51, *Accounting and Financial Reporting for Intangible Assets*, which was issued in June 2007, provides guidance for these questions and many more by clarifying the financial reporting requirements for intangible assets established in Statement 34. GASB believes that clarifying these requirements will reduce inconsistencies in reporting intangible assets within a government and will enhance the comparability of financial reports across governments. Statement 51 will be effective for state and local governments with fiscal years beginning after June 15, 2009. The reporting requirements of the new standard are explained below alongside specific examples of its application.

Background

After almost a decade of deliberations over a new financial reporting model for state and local governments, in 1999 GASB issued Statement 34. Statement 34 resulted in a major shift in the field of governmental accounting. In addition to modifying the governmental and proprietary fund financial statements, Statement 34 requires state and local governments to report economic resources on a full accrual basis in government-wide financial statements. This government-wide approach to financial reporting requires accounting for all capital assets, including intangible assets.

Many preparers of government financial reports began to ask questions about the reporting of intangible assets after reading paragraph 19 of GASB Statement 34.

Paragraph 19 states that capital assets include "land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or *intangible assets* that are used in operations and that have initial useful lives extending beyond a single reporting period" [emphasis added].

Some of the preparers' questions stemmed from not understanding the meaning of "intangible assets that are used in operations." Questions arose about whether intangible assets should be viewed as they were in Accounting Principles Board (APB) Opinion 17, *Intangible Assets*, which, since its issuance in 1970, had been the authoritative intangible-asset guidance for governments. In general, APBO 17 identified as intangible assets items such as patents, trademarks, and copyrights, but it did not define intangible assets based on their characteristics. Therefore, some preparers questioned whether some items common to governments—such as computer software, water rights, timber rights, and development rights—were intangible assets.

Identifying Intangible Assets

Paragraph 2 of Statement 51 explains that an intangible asset must first be an asset. For state and local governments, Concepts Statement 4, *Elements of Financial Statements*, defines an asset as a resource that has a present service capacity and is presently controlled by the government (paragraph 8). Paragraph 6 of Concepts Statement 4 explains that "a resource is an item that can be drawn on to provide services to the citizenry." Present service capacity is an asset's existing capability to enable a government to provide services (Concepts Statement 4, paragraph 9). To be an *intangible* asset under the Statement 51 provisions, an asset must have three characteristics:

- Not have a physical (tangible) substance;
- Be nonfinancial in nature; and
- Have an initial useful life that is greater than one reporting period.

Intangible assets generally result from legal or contractual rights and clearly have no physical substance. For example, accountants have long viewed trademarks, copyrights, and royalty interests as intangible assets. Some intangible assets, however, are closely related to tangible assets. A right-of-way easement for a road depends on a tangible asset—land—to enable a government to provide transportation services. The appropriate question to ask when attempting to determine whether an intangible asset exists is, "What is the asset?" A right-of-way easement is a contractual right that does not have physical substance even though the easement results in the government's ability to use the surface of land for a specific purpose—a road. The right-of-way easement, thus, is an intangible asset. Likewise, water rights are an intangible asset.

Accounts receivable and investment securities are assets that do not have a physical substance and, therefore, meet the first characteristic for an intangible asset. Such assets do not meet the second characteristic, however, which requires that intangible assets be nonfinancial in nature. An asset is nonfinancial in nature if it is not in a monetary form (like cash or investment securities) and is neither a claim or right to assets in a monetary form (like receivables), nor a prepayment for goods or services (Statement 51, paragraph 2). Therefore, accounts receivable and investment securities are not considered to be intangible assets.

All capital assets, including intangible assets, must have an initial useful life that extends beyond one reporting period. If an item does not provide service capacity beyond a single reporting period, it does not qualify as an asset. The cost of such an item is expensed when incurred.

What is not included? Governments have certain powers, by their inherent nature or through statutes, which allow them to compel or control the actions of others. For example, governments often have the power to tax, the power of eminent domain, and the power to assess fees for licenses or permits that allow individuals or businesses to engage in certain actions. These powers of a governmental entity are not considered to be intangible assets, because powers do not meet the definition of an asset. For example, a government may have the power to tax real property within its jurisdiction. This power is not considered an asset, because it does not have present service capacity; that is, it does not exist until the government exercises its power and assesses a property tax. At that point, the government has an asset: property taxes receivable.

Governments may acquire or create intangible assets that they intend to use primarily to earn income. Universities, for example, are sometimes given copyrights on books or recordings so that they can earn royalties to finance their programs. They may also develop processes that they patent for the purpose of selling them to commercial enterprises. Although these copyrights and patents meet the description of intangible assets, they are not included within the scope of Statement 51. Intangible assets that governments acquire or create to directly *obtain income or profit* should be accounted for as investments.

Assets resulting from capital lease transactions and goodwill created through the combination of a governmental entity and another entity also are not included in the scope of Statement 51. GASB may consider as a future project providing specific reporting guidance for goodwill and other assets acquired through government combinations. Until then, governments generally should follow the "pooling of interest" financial reporting guidance in APBO 16, *Business Combinations*. Governments generally should not follow the financial reporting provisions required for business combinations in SFAS 141, *Business Combinations*, nor should governments follow the "goodwill" reporting provisions required for businesses in SFAS 142, *Goodwill and Other Intangible Assets*.

Recognition in Financial Statements

Intangible assets within the scope of Statement 51 that are "identifiable" should be reported and disclosed in a government's financial statements like other capital assets. Statement 51, paragraph 6, explains that an intangible asset is identifiable when either of the following criteria is met:

- The asset is separable; that is, the asset is capable of being separated or divided from the government and sold, transferred, licensed, rented, or otherwise exchanged, either individually or together with a related contract, asset, or liability; or

- 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.

The general capitalization rules for intangible assets are the same as for other capital assets (Statement 34, paragraph 19). If purchased, the amount to be capitalized is the intangible asset's historical purchase price. If donated to the government, the amount to be capitalized is the fair value of the intangible asset at the time it is acquired.

Identifiable intangible assets should be reported as part of capital assets in the government-wide, proprietary fund, and fiduciary fund statements of net assets in accordance with Statement 34's reporting provisions. Intangible assets that are financed through governmental fund activities (such as taxes, intergovernmental revenues, other nonexchange revenues, and general obligation borrowings) are generally reported in the governmental activities column of the government-wide statement of net assets. Intangible assets that are financed through enterprise fund activities are generally reported in the business-type activities column of the government-wide statement of net assets. Capital assets, including intangible capital assets, that are being depreciated or amortized should be reported separately from capital assets that are not being depreciated or amortized.

Amortization

Amortization is the allocation of the cost of intangible assets over their estimated useful lives. Reporting amortization expense allows governments to present information to users of financial statements about the cost of providing services. Amortization expense for intangible assets that have finite useful lives is recognized in the government-wide statement of activities and the proprietary funds' statement of revenues, expenses, and changes in net assets. This is consistent with the amortization provisions for intangible assets with finite lives in SFAS 142.

GASB Statement 51 limits the amortization period of intangible assets arising from contractual or other legal rights to those periods for which service capacity is expected to exist. For example, a town's right to use water from a lake for a period of 20 years generally would be amortized over a 20-year period. If, however, that same town had a right to renew the water rights for an additional 10 years for a nominal amount, it should amortize the water right over a period of 30 years, assuming evidence exists that the town would seek renewal.

Intangible assets that have no limiting factors (legal, contractual, regulatory, technological, or otherwise) regarding their estimated useful life are considered to have an indefinite useful life and are not amortized. For example, a right-of-way easement for land under a road that is expected to be used indefinitely should not be amortized. It would be reported as part of capital assets not being depreciated or amortized in the statement of net assets.

GASB's decision to not amortize intangible assets with indefinite useful lives is consistent with the amortization provisions of SFAS 142. GASB Statement 51 does not, however, require governments to annually test intangible assets with indefinite useful lives for impairment, as is required for such assets held by business enterprises.

Governmental Funds

Governments should report outlays for intangible assets in their governmental fund financial statements like any other capital outlay. That is, capital outlays are not capitalized and recognized in the governmental funds' balance sheet. Instead, such outlays represent the use of current financial resources and should be recognized as expenditures in the governmental funds' statement of revenues, expenditures, and changes in fund balances.

Internally Generated Intangible Assets

Some intangible assets are created or produced by a government, produced by a government contractor, or acquired from a third party in a condition that requires more than a minimal incremental effort by the government to begin to achieve an expected level of service capacity (Statement 51, paragraph 7). These intangible assets are considered to be internally generated intangible assets. Governments internally generate various types of intangible assets, including computer software, patents, copyrights, and trademarks.

Determining the amount that should be capitalized (and recognized in the statement of net assets) is more difficult if intangible assets are internally generated than if similar assets are purchased or donated in a ready-to-use condition. It is more difficult because governments must determine when an asset can begin to be recognized. To do this, governments must consider the nature of the project, the expected service capacity of the planned intangible asset, the project's technological feasibility, and the government's intent to complete the project. Statement 51, paragraph 8, requires that outlays for internally generated intangible assets be capitalized using a specified-conditions approach. That is, outlays for internally generated intangible assets should only begin to be capitalized when all of the following specified conditions have occurred:

- 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;
- Demonstration of the technical or technological feasibility for completing the project so that 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 a multiyear project, continue development of the intangible asset (paragraph 8).

Any outlays for internally generated intangible assets made prior to meeting each of these three conditions should be expensed in the period incurred. Also, a stoppage in the development of an internally generated intangible asset is considered an indicator of impairment for purposes of applying GASB Statement 42, *Accounting and Financial Reporting for Impairment of Capital Assets and Insurance Recoveries*. (The other indicators of impairment in Statement 42 would apply, when applicable, to all types of intangible assets.) An impaired internally generated intangible asset should be reported at the lower of its carrying or fair value in the statement of net assets. The impairment loss should be reported in the statement of activities as a program or operating expense, special item, or extraordinary item, as appropriate (Statement 42, paragraph 17).

Internally Generated Computer Software

Internally generated computer software is likely the most prevalent type of internally generated intangible asset, and it is the most significant in terms of outlay for state and local governments. It includes software developed by a government's own employees or by a third party on behalf of the government, as well as commercially available software to which more than minimal incremental effort is applied to ready it for use in the government's operations (Statement 51, paragraph 9).

Statement 51 specifically explains how outlays related to this type of internally generated intangible asset should be recognized in a government's financial statements under the specified-conditions approach. To help accountants determine which outlays for internally generated software should be capitalized, GASB identifies three stages of activities involved in creating and installing software as follows:

- Preliminary project stage, in which ideas, needs, and alternatives for developing the software are identified;
- Application development stage, in which design, software configuration, software interfacing, coding, installing hardware, and testing (including parallel processing) occur; and
- Post-implementation/operation stage, in which application training and software maintenance activities occur (Statement 51, paragraph 10).

Outlays associated with the preliminary project and post-implementation/operation stages should be expensed as incurred (Statement 51, paragraphs 11, 13). Outlays associated with the application development stage should be capitalized only after the preliminary project stage is complete and "management implicitly or explicitly authorizes and commits to funding ... the software project" (Statement 51, paragraph 11). Management, for example, may authorize or commit to funding by approving a budget for the project, by contracting with a third party to provide technical support for software development, or by hiring or designating employees for the project.

After the software is substantially complete and ready for its intended use, any further outlays generally should be expensed. A government, however, may decide to make internally generated modifications to internally generated or purchased computer software that it is currently using. Outlays for modifications that increase the capacity, efficiency, or useful life of software should be capitalized if they meet the previously discussed capitalization requirements for the application development stage.

GASB's guidance for computer software is generally consistent with the AICPA's Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and with the Federal Accounting Standards Advisory Board's (FASAB) Statement 10, *Accounting for Internal Use Software*.

Effective Date and Transition

Statement 51 is effective for all financial statements for periods beginning after June 15, 2009, although earlier application is encouraged. If comparative financial statements are presented, all prior-period financial statements should be restated to apply the Statement 51 provisions, if practical. If retroactive restatement of prior-period financial statements is not practical, then the cumulative effect of applying Statement 51 should be reported as a restatement of beginning equity for the earliest period restated, and the reason for not restating prior periods should be disclosed.

Governments are generally required to report intangible assets retroactively, unless those assets are considered to have indefinite useful lives as of the effective date of Statement 51, or unless they are considered internally generated. GASB, however, recognized that some governments would have difficulty applying Statement 51 because they have insufficient records to determine the historical cost for existing intangible assets. In this case, governments that were considered Phase 1 or Phase 2 for the purpose of implementing Statement 34 may instead report the "estimated historical cost" for intangible assets acquired in fiscal years ending after June 30, 1980. Governments that were Phase 3 governments for the purpose of implementing Statement 34 are not required, but are encouraged, to report these intangible assets retroactively.

Although they are not required to do so, governments may choose to report retroactively those intangible assets that have indefinite useful lives or, under certain circumstances, internally generated intangible assets. Internally generated intangible assets (including ones that are in development as of the effective date of Statement 51) may only be reported when the specific conditions approach can be applied to determine their historical cost. The government's policy for reporting these intangible assets should be disclosed as part of its summary of significant accounting policies (APBO 22, *Disclosure of Accounting Policies*). ❑

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