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GASB Update – Statements 51, 53, 55 - 58

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GASB 51

Background

- Project born out of questions raised over description of capital assets in Statement 34:
  - "capital assets includes land, easements, buildings…and all other tangible and *intangible assets* that are used in operations and that have initial useful lives extending beyond a single reporting period"
- Uncertainty in practice as to what was meant by *intangible assets* in the description

Common Types of Intangible Assets

- Right-of-way easements
- Other types of easements
- Patents, copyrights, trademarks
- Land use rights
- Licenses and permits
- Computer software
  - Purchased or licensed
  - Internally generated
  - Websites

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Background

- GASB survey results showed inconsistency in practice:
  - Whether or not intangible assets were being recorded
  - Measurement of donated intangible assets
  - Amortization
- Objective of Statement 51 is to resolve any inconsistencies in practice

Overview

- Statement 51 addresses the following aspects of reporting intangible assets:
  - Description
  - Classification
  - Recognition
    - General recognition requirement
    - Broad approach to recognizing internally generated intangible assets
    - Specific approach to recognizing internally generated computer software
  - Measurement
    - Initial measurement
    - Amortization
  - Impairment
  - Disclosures
  - Transition provisions

Description

- An intangible asset is an <u>*asset*</u> that possesses all of the following characteristics:
  - Lack of physical substance
  - Nonfinancial nature
  - Initial useful life extending beyond a single reporting period

Lack of Physical Substance

- When determining lack of physical substance, do not consider:
  - Modes of containment
    - For example, computer software lacks physical substance although it may be distributed on a CD
  - Associated tangible property
    - Easements lack physical substance even though they are associated with land
    - Capacity rights to a wastewater treatment plant

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Nonfinancial Nature

- Asset has nonfinancial nature if it is NOT:
  - In a monetary form
    - Cash
    - Investment securities
  - A claim or right to an asset in monetary form
    - Receivables
    - Derivatives
  - A prepayment for goods or services

Basic Guidance

- All intangible assets subject to Statement 51 should be classified as capital assets:
  - All existing authoritative guidance related to capital assets should be applied to these intangible assets
  - Since considered capital assets, not reported as assets in governmental fund financial statements
- Scope exceptions:
  - Intangible assets acquired or created primarily for directly obtaining income or profit
  - Capital leases
  - Goodwill from a combination transaction

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Recognition

- An intangible asset should be recognized only if it is identifiable:
  - Asset is separable, i.e. capable of being separated and sold, transferred, licensed, etc.

    -OR-

  - Asset arises from contractual or other legal rights, regardless of whether rights are separable

Internally Generated Intangible Assets

- Internally generated intangible assets (IGIA) are:
  - Created or produced by the government or an entity contracted by the government; or
  - Acquired from a third party but require more than minimal incremental effort to achieve expected service capacity
- Statement provides a specified-conditions approach to recognizing outlays associated with IGIA
- Guidance may result in capitalization of certain R&D costs previously expensed under FASB Statement No. 2

Internally Generated Intangible Assets (continued)

- Outlays incurred related to an IGIA that is considered identifiable should be capitalized only upon the occurrence of all of the following:
  - Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the asset upon completion of the project;
  - Demonstration of the technical or technological feasibility for completing the project so that the asset will provide its expected service capacity;
  - 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
- Outlays incurred prior to meeting the criteria should be expensed as incurred—no “recycling” of expenses

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Internally Generated Computer Software

- Specific guidance on applying the IGIA specified-conditions approach for internally generated computer software (IGCS) is provided
- IGCS is either:
  - Developed in-house by government personnel or a contractor on their behalf; or
  - Commercially available software modified using more than minimal incremental effort before being put in operation
- Guidance based on development stages similar to AICPA SOP 98-1

Internally Generated Computer Software (continued)

- Activities associated with IGCS should be categorized in one of three development stages:
  - Preliminary project stage
    - Conceptual formulation and evaluation of alternatives
    - Determination of existence of needed technology
    - Final selection of alternatives
  - Application development stage
    - Design of the chosen path
    - Coding
    - Installation to hardware
    - Testing and parallel processing
  - Post-implementation/operation stage
    - Application user training
    - Software maintenance

Internally Generated Computer Software (continued)

- IGIA specified-conditions criteria considered met for IGCS when:
  - The activities in the preliminary project stage are completed
  - Management authorizes and commits to funding the project
- For commercially available software that is IGCS, these criteria are generally considered met upon government’s commitment to purchase or license software

Internally Generated Computer Software (continued)

- Reporting of activity outlays:
  - Preliminary project stage—expense as incurred
  - Application development stage—capitalize once criteria is met; cease capitalizing when software is operational
  - Post-implementation/operation stage—expense as incurred
- Reporting should be based upon nature of activity, not timing of its occurrence

Internally Generated Computer Software – Preliminary Project Stage Activities

- Preliminary project stage activities generally drive toward determining a final approach for the project:
  - Making strategic decisions to allocate resources between alternative projects
  - Determining performance requirements for project—e.g. user needs study
  - Determining systems requirements for the project and existence of needed technology
  - Exploring alternative means of achieving the project performance requirements
  - Selecting a vendor if commercially available software is to be acquired
  - Selecting a consultant to assist in the development or installation of the computer software

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Internally Generated Computer Software

- 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 only if necessary to make software operational—otherwise post-implementation/operation stage
- Consider human resources system vs. vendor information database (Q Z.51.14)
- Statement 51 provision differs from SOP 98-1
  - Notion of ancillary charges for capital assets

Internally Generated Computer Software (continued)

- Generally apply the development-stage approach to individual modules of multi-module IGCS project (Q Z.51.12)
- Training of employees involved with developing IGCS is not capitalizable (Q Z.51.15)
- Licensing agreement costs for IGCS should be broken into components for application of development-stage approach (Q Z.51.16)
- Reporting of outlays from business process reengineering should be separate from reporting of IGCS outlays (Q Z.51.17)
- NCGA 5/FASB 13 guidance on leases is not applicable to a license to use software (Q Z.51.21)
  - Report asset and liability if installment payments are made over multiple periods

Internally Generated Computer Software (continued)

- Reporting costs of internally generated modifications of software should follow development stage approach if the modification results in:
  - — An increase in the functionality of the software
  - — An increase in the efficiency of the software; or
  - — An extension of the estimated useful life of the software
- If modification does not result in one of the above, associated outlays should be expensed as incurred
- Extension of useful life without increased functionality or efficiency expected to rarely occur

Impact of Internally Generated Computer Software Guidance

- Clients will have to establish policies and procedures to apply the IGCS guidance:
  - Classification of activities related to development of software
  - Job costing and cost accumulation
  - Assessment of software capitalization thresholds and evaluation of projects
  - Assessment of internally developed modifications of software
  - Evaluation of useful lives of software systems
- Funding sources for software projects:
  - Availability of bond funds for software projects
  - Changes in federal reimbursement for software costs

Measurement

- Intangible assets follow measurement guidance for capital assets:
  - Historical cost
  - If donated, estimated fair value at date of donation
- BFC provides Board's non-authoritative views as to determining fair value of donated right-of-way easements for roadways
- Intangible assets excluded from scope because acquired or created to generate income or profit generally should follow guidance for investments

Amortization

- Existing guidance for depreciation of capital assets generally applies to amortizing intangible assets
  - No mandatory maximum amortization period
- Exception for intangible assets with indefinite useful lives:
  - No factors currently exist that limit the useful life of the asset
  - A useful life that must be estimated does not mean indefinite useful life
    - Permanent right-of-way easement vs. computer software
  - Intangible assets with indefinite useful lives should not be amortized (Q Z.51.27)

Amortization

- Useful life of an intangible asset that arises from contractual or legal rights should not exceed the legal term of the rights
- Renewal periods can be considered if there is evidence that:
  - Renewal will be sought and will be able to be achieved, considering any third-party consent; and
  - Any anticipated outlays related to renewal are nominal in relation to the level of service capacity expected to be obtained through the renewal

Impairment

- The provisions of Statement 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, generally should be applied to determine impairment of intangible assets
- “Development stoppage” added to the impairment indicators in Statement 42
- Q Z.51.28 details examples of circumstances that may indicate impairment

Note Disclosures

- No note disclosure requirements specific to intangible assets
- Intangible assets should be incorporated into the capital asset note disclosures
- Q Z.51.29 discusses inclusion of intangible assets in major classes of capital assets

Effective Date and Transition

- Effective date is fiscal periods beginning after June 15, 2009
- Provisions generally should be retroactively applied
- Exceptions for retroactively reporting intangible assets:
  - Permitted but not required for IGIA to the extent specified-conditions approach can be applied
  - Permitted but not required for intangible assets with indefinite useful lives at transition
  - Required for all other intangible assets acquired in fiscal years ending after June 30, 1980 by phase 1 or 2 governments
  - Encouraged but not required for all other intangible assets of phase 3 governments

Effective Date and Transition

- Indefinite useful life provisions should be applied retroactively only if asset has indefinite useful life at transition
- Land use rights associated with property already owned by government should not be reported as intangible assets separate from the property (Q Z.51.30)
- Additional Statement 51 implementation guidance is included in the 2008 Comprehensive Implementation Guide

GASB 53

Examples of Derivatives

- Swaps
  - Forward-based contracts in which two parties agree to swap streams of payments for a specified period of time
    - Interest rate swaps
    - Commodity swaps
- Forward/Futures Contracts
  - Contract to purchase/sell a specific quantity of a financial instrument, currency, or commodity at a specific price with delivery and settlement at a specified future date
  - Futures are standardized forward contracts sold in a market

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Examples of Derivatives (continued)

- Options (puts, calls, caps, floors, collars)
  - Allow, but do not require, the holder to buy (call) or sell (put) a commodity or financial instrument at a specified price during a specified period or on a specific date
  - Governments can write (give away) or purchase (hold) the option
  - Examples include puts, calls, caps, floors, collars
  - “Swaptions” give the purchaser of the option the right, but not the obligation, to enter into an interest rate swap

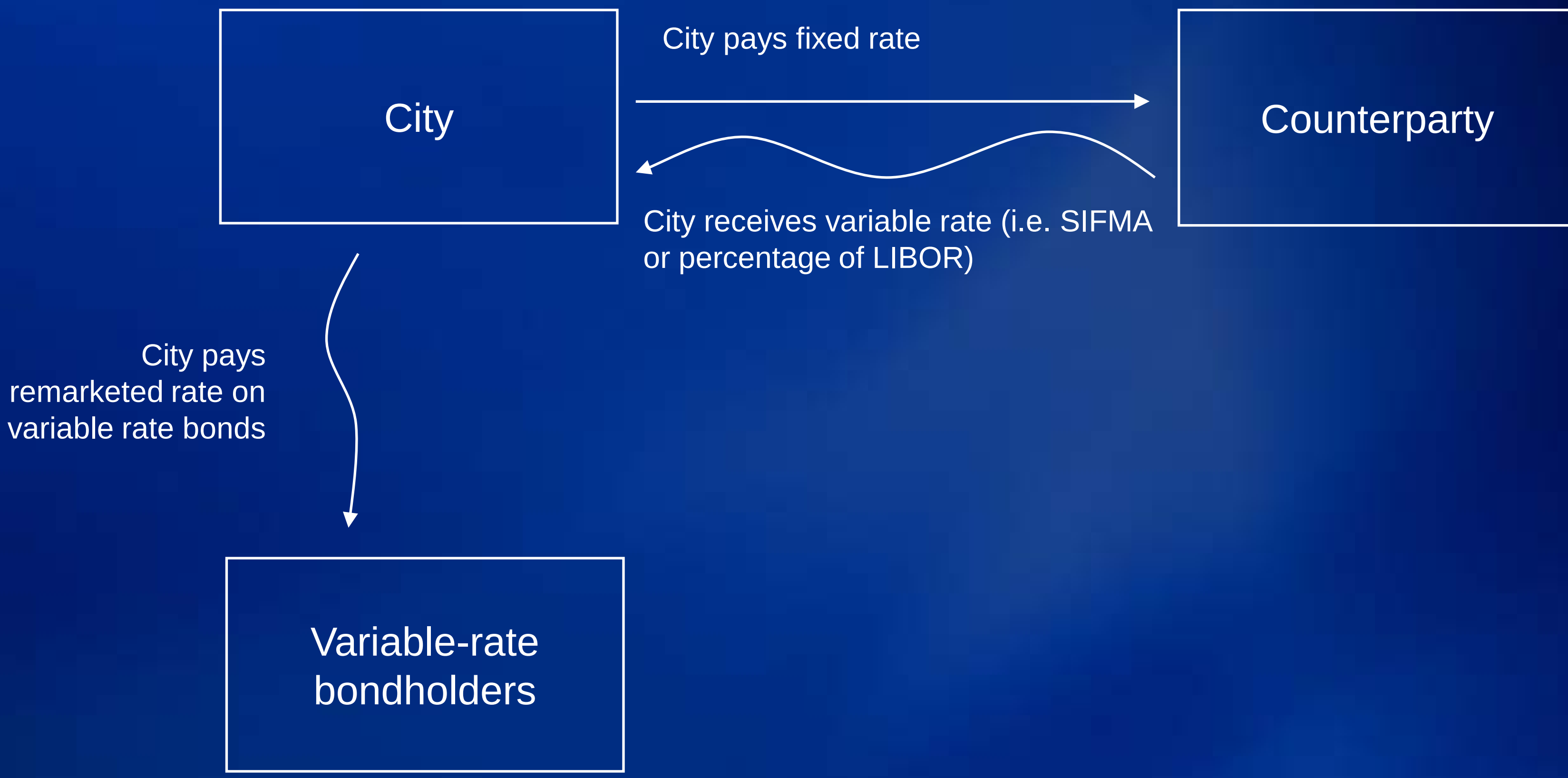
What is an Interest Rate Swap?

- An interest rate swap is a derivative that a government enters into with a counterparty where the government “swaps” the rate they are paying on outstanding bonds for another rate
- Generally the most common type of derivative entered into by governments
- Two common types of interest rate swaps:
  - Pay-fixed, receive variable
  - Pay-variable, receive fixed

Pay-Fixed, Receive-Variable Swap

- Governments generally enter into a pay-fixed, receive variable swap when they have issued variable-rate bonds and they want to “create” a fixed rate on the bonds
- In a pay-fixed, receive-variable swap:
  - — The government pays the swap counterparty a fixed rate
  - — The swap counterparty pays the government a variable rate
  - — The variable rate received by the government is intended to offset the variable rate paid to the bondholders
- Actual swap payments are based on the rates and the “notional amount” of the swap which often matches the outstanding amount of the corresponding debt

Pay-Fixed, Receive-Variable Swap (continued)



Pay-Variable, Receive-Fixed Swap

- Governments generally enter into a pay-variable, receive-fixed swap when they have issued fixed-rate bonds and they want to “create” a variable rate on the bonds
- In a pay-variable, receive-fixed swap:
  - — The government pays the swap counterparty a variable rate
  - — The swap counterparty pays the government a fixed rate
  - — The fixed rate received by the government is intended to offset the fixed rate paid to the bondholders
- Actual swap payments are based on the rates and the “notional amount” of the swap which often matches the outstanding amount of the corresponding debt

Pay-Variable, Receive-Fixed Swap (continued)

Definition of a Derivative

- A derivative instrument is a financial instrument or contract that has <u>all</u> of the following characteristics:
  - Settlement factors
  - Leverage
  - Net settlement
- A derivative instrument can be a freestanding instrument or embedded within another instrument or contract
- Some scope exceptions to this definition
  - Normal purchases and normal sales

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Settlement Factors

- Settlement factors determine the amount of the derivative's settlement payment
- To meet the settlement factors characteristic, the instrument must have:
  - One or more reference rates (underlyings)
  - One or more notional amounts or payment provisions or both
- For an interest rate swap:
  - Reference rate is the interest rate index
  - Notional amount is the stated dollar amount of the swap; it often matches the amount of the related debt

Leverage

- An instrument meets the leverage characteristic if it requires little or no net upfront investment yet responds to market changes similarly to contracts that require net investment
- Interest rate swaps:
  - Typically require no upfront payment to execute
  - Will have changes in fair value similar to a fixed-rate debt security as market interest rates change

Net Settlement

- Net settlement is a one-way transfer of an asset, usually cash, from the party in a loss position to the party in a gain position
- An instrument meets the net settlement characteristic if:
  - Its contract terms explicitly require or implicitly permit net settlement
  - It can be readily settled net outside the contract through a market mechanism; or
  - It provides for delivery of an asset that is readily convertible to cash or is itself a derivative instrument
- Interest rate swaps are typically required to be settled through a net cash payment

Basic Accounting Guidance

- Report derivatives at fair value on statements of net assets
- Periodic changes in fair value reported in the change statements as investment income unless derivative is a “hedging derivative instrument”
- Hedge accounting must be applied for hedging derivative instruments:
  - <u>ALL</u> changes in fair value of derivative reported as deferred inflows or deferred outflows

Scope Exclusion

- The measurement provisions of the Statement should <u>NOT</u> be applied to derivatives reported in governmental funds
- In these funds, derivatives should continue to be reported at historical cost, which is most often zero

Effective Date and Transition

- Effective for financial statements for periods beginning after June 15, 2009
- Provisions should be retroactively applied; restate prior periods presented if practical
- Perform effectiveness testing of existing HDIs at the end of the period of implementation:
  - If effective, apply as if effective since inception
  - If ineffective, test as of end of prior period:
    - If effective, write-off deferral during implementation period
    - If ineffective, fair value incorporated into cumulative effect of change in accounting

GASBs 55 - 58

GASB Statements 55 and 56

- GASB Statements 55 and 56 bring accounting and financial reporting guidance currently present in AICPA literature into GASB literature:
  - Statement 55—GAAP Hierarchy (AU 411.12)
  - Statement 56:
    - Related party transactions (AU 334)
    - Subsequent events (AU 560)
    - Going concern considerations (AU 341)
- Guidance brought into GASB literature essentially "as is"
- Statements effective immediately upon issuance (3/09)

GASB Statement 55

- Four levels of GAAP for state and local governments:
  - Level A
    - GASB Statements and Interpretations
  - Level B
    - GASB Technical Bulletins
    - AICPA Audit Guides and SOPs applicable to SLGs cleared by GASB
  - Level C
    - AICPA Practice Bulletins applicable to SLGs cleared by GASB
  - Level D
    - GASB Implementation Guides
    - Prevalent industry practice
- Consider other accounting literature when there is no guidance in Levels A-D

GASB Statement 56

- Related Party Transactions
  - Recognize using substance over form
  - Disclose certain related party transactions
- Subsequent Events
  - Recognized events
    - Similar to Type 1 events
    - Provide evidence of conditions existing at balance sheet date
    - Adjust financial statements
  - Nonrecognized events
    - Similar to Type 2 events
    - Provide evidence of conditions that exist only subsequent to balance sheet date
    - Do not adjust financial statements, but potentially disclose
  - Reminder of potential discussion of subsequent events in MD&A

GASB Statement 56

- Going Concern
  - Management is responsible for evaluating whether there is substantial doubt about ability to continue as a going concern
  - Timeframe is 12 months from year-end, but known information about ability to continue beyond 12 months should be considered
  - If there is substantial doubt, disclosures should be made describing the conditions and management's plans to address them
  - Reminder about potential disclosure of going concern conditions in MD&A

GASB Statement 57

***OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans* (Issued 12/09)**

- Objective is to address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers).
- Statement amends Statement No. 45 to permit an agent employer that has an individual-employer OPEB plan with fewer than 100 total plan members to use the alternative measurement method, at its option, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates.
- Statement clarifies that when actuarially determined OPEB measures are reported by an agent multiple-employer OPEB plan and its participating employers, those measures should be determined as of a common date and at a minimum frequency to satisfy the agent multiple-employer OPEB plan's financial reporting requirements.
- Provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011.

GASB Statement 58, Why?

- **WSJ 4/30/10 - *Harrisburg Misses Bond Payment - Insurer Steps In as Pennsylvania City Considers Bankruptcy*** According to a report issued by Management Partners Inc., a consulting firm hired to assess the city's financial situation, Harrisburg's total deficit will, over the next five years, balloon to $164 million, $144.8 million of which stems from the incinerator debt payments. Nearly $70 million of that total is due in 2010.
- **WSJ 3/24/10 - *Bankruptcy For Jefferson County?*** The county, home to Birmingham, is struggling with about $4 billion in debt from the issuance of bonds and related interest-rate swaps that soured in late 2007. The county issued the debt to finance water and sewer system improvements
- **WSJ 5/28/09 *California Cities Face Bankruptcy Curbs.*** The bill was sparked by the bankruptcy filing last year of Vallejo, Calif., just north of San Francisco. Vallejo's city leaders partly blamed work contracts with police and firefighters for pushing the city into bankruptcy, and won permission from a bankruptcy court in March to scrap its contract with the firefighters' union.

GASB Statement 58

- ***Accounting and Financial Reporting for Chapter 9 Bankruptcies* (Issued 12/09)**
- Objective is to provide accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. It requires governments to remeasure liabilities that are adjusted in bankruptcy when the bankruptcy court confirms (that is, approves) a new payment plan.
  - For accounts payable, notes, debentures and bonds, and related interest payable, Statement requires governments to base remeasurement on the new payment plan.
    - Reductions in future interest payments would result in lower interest costs reported in future periods.
    - Reductions to principal or to accrued interest payable may result in gains reported at the time of the reduction. If the new payment plan does not indicate whether it reduces principal payments or future interest payments that have not been accrued, the debt should be remeasured at the present value of the future payments using the original discount rate, and a gain should be reported at the time of the reduction.

GASB Statement 58, Continued

- For leases, pollution remediation liabilities, and liabilities for pension and other postemployment benefit plans, this Statement requires remeasurement based on existing authoritative guidance. However, if a benefit plan is rejected in bankruptcy and becomes general unsecured debt, this Statement requires the existing liability to be removed and a new approved payment plan to be recognized as a judgment, with a gain or loss recognized for the difference.
- For governments that are not expected to emerge from bankruptcy as going concerns, this Statement requires remeasurement of assets to a value that represents the amount expected to be received.
- This Statement classifies gains or losses resulting from remeasurement of liabilities and assets as an extraordinary item.
- Governments that have filed for bankruptcy are required to disclose information regarding, among other things, the pertinent conditions and events giving rise to the petition for bankruptcy, the expected gain, and the effects upon services.
- This Statement is effective for reporting periods beginning after June 15, 2009.