



GASB Update

Jack Reagan
Audit Partner, KPMG LLP
May 25, 2010

Effective Dates – June 30

- June 30, 2010
 - Statement 51
 - Statement 53
- June 30, 2011
 - Statement 54





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



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 asset 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

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



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



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



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



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?

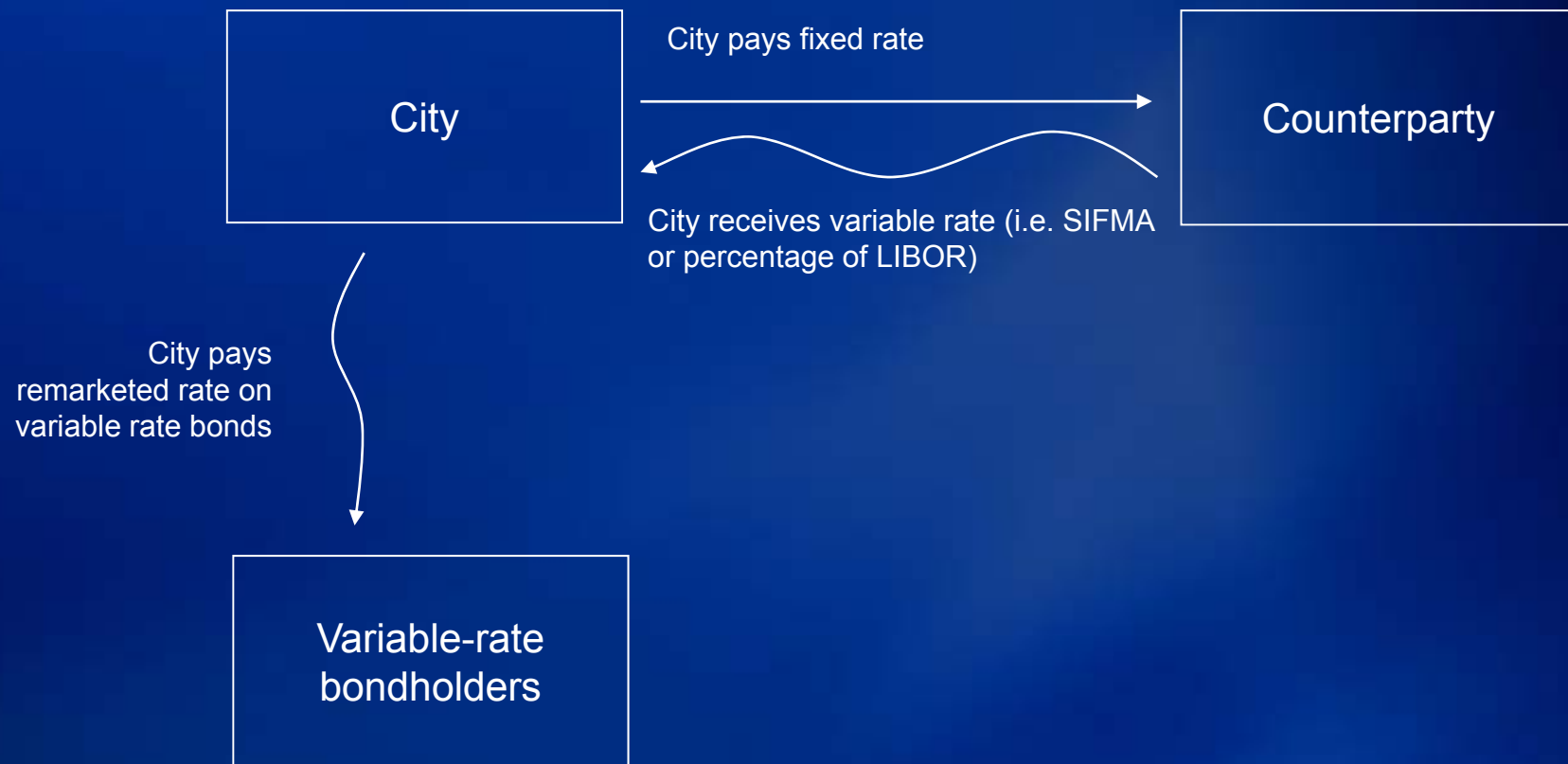
- An interest rate swap is a derivative that a government enters into with a counterparty where the government “swaps” the rate they are paying on outstanding bonds for another rate
- Generally the most common type of derivative entered into by governments
- Two common types of interest rate swaps:
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



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:
 - ALL changes in fair value of derivative reported as deferred inflows or deferred outflows



Scope Exclusion

- The measurement provisions of the Statement should NOT 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





GASB 55 & 56

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



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

