INTANGIBLES: GOVERNMENTS' FORGOTTEN CAPITAL ASSET

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ABSTRACT

Since the issuance of GASB Statement No. 34, some governments have sought guidance from GASB concerning the proper reporting of intangible assets, including the accounting and reporting of any impairment of such assets. Much like many corporate firms, governments are finding intangible assets to be an increasingly important economic resource. Inquirers seem to be most concerned with intangibles such as air rights, land easements, water rights, and software development costs. Currently, the GASB literature contains no guidance that particularly addresses intangibles. The purpose of this paper is to explore how intangible resources should be valued, recognized, and presented in the financial reporting of state and local governments.

Introduction

With the issuance of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, preparers of state and local government financial reports have focused much of their attention on gathering the requisite information to report general capital assets—particularly general infrastructure assets. Fortunately, the reports of early implementers indicate that most of these governments have reported their general infrastructure assets in the year that they implemented Statement 34. However, questions raised by preparers about the reporting requirements of an often "infrastructure" related type of capital assets—intangible assets—suggest that confusion still remains about the new capital asset reporting requirements. A sampling of questions that have been asked about intangibles include:

- "Do we have to report the land under our roads if we do not own the land, but only have a right-of-way? Does it make a difference if the land was donated instead of purchased?"
- "Do we have to report air rights?"
- "Our government is purchasing development rights to farmland; what should we report under Statement 34?"
- "Should any or all of our intangible assets be amortized?"

This paper intends to explore how intangible resources should be valued, recognized, and presented in the financial reporting of state and local governments.

Background

Paragraph 19 of GASB Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* 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* [emphasis added] that are used in operations and that have initial useful lives extending beyond a single reporting period." Further, paragraph 21 of Statement 34 explains that capital assets should be depreciated over their estimated useful lives. The GASB literature contains no other guidance that particularly addresses reporting intangible assets. So, in the absence of specific pronouncements by GASB, where does one look for guidance? The AICPA GAAP hierarchy, as set forth in Statement of Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, recognizes GASB as the standards setting body for state and local governments, including governmental not-for-profit (NFP) organizations. Can FASB standards be used to successfully account for intangibles in governmental entities? The answer is a qualified yes. SAS No. 69 provides that "in the absence of a pronouncement covered by rule 203 [ET section 203.01] or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances" (AICPA 1988). This "other accounting literature" includes FASB's officially established accounting principles for nongovernmental entities (AICPA 2004).

Identification of Intangible Assets

Definition of Asset

The conceptual framework of accounting defines the basic kinds of accounts—assets, liabilities, equity, revenues, and expenses—and presents and explains the underlying concepts and rules that govern the recognition and valuation of these accounts. In particular, SFAC 6 defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. For an item to qualify as an asset, three characteristics must be present:

- The item must provide probable future economic benefit that enables it to provide future net cash inflows;
- The entity must be able to receive the benefit and restrict other entities' access to that benefit; and
- The event that provides the entity with the right to the benefit has occurred.

In addition, all assets must possess "service potential," often called future economic benefit, which most often takes the form of future net cash inflows.

Characteristics of Intangible Assets

Intangible assets generally result from legal or contractual rights and have no physical substance. Four other characteristics differentiate intangible assets from tangible assets:

1. There is generally a higher degree of uncertainty as to the expected future economic benefits the entity may derive from intangible assets.
2. The value of intangible assets is subject to wider variability because that value may depend on competitive conditions.
3. Intangible assets may have value only to a particular entity, i.e., they may have no value in a market or in a market exchange.
4. Intangible assets with indefinite lives are not expensed over time.

Although the definition of intangible assets is rather straightforward, accounting and reporting for such assets is not always clear. Prior to the implementation of Statement 34, it appears that the reporting of intangibles was of little or no concern to some governments because depreciation of capital assets was optional. However, times have changed in the governmental financial reporting world and capital assets, including intangibles, are now reported in the government-wide financial statements using an economic resources measurement focus. Accounting for intangibles is starting to gain prominence in governmental accounting, and rightfully so. Intangibles often represent significant economic resources (air rights, water rights, easements, trademarks, etc.) of governments.

Measurement and Valuation

Cost of Asset

GAAP identifies five distinct methods by which an asset may be valued: historical cost (net book value), current cost (replacement cost), current market value (current exit value), net realizable value (expected exit value), and present value (FASB 1976; FASB 1984).

Following the cost principle, assets are generally recorded at historical cost, where cost is either the fair market value of the consideration (cash or equivalent) given up to acquire the asset or the fair market value of the asset, whichever is more reliable. That is, all expenditures necessary to place the asset in a position and condition for its intended use are part of the value to be recorded at acquisition. Thereafter, the cost of the asset, less its estimated residual value, is allocated among the periods of its use and, at any point in time, the carrying value of the asset is defined as the historical cost of the asset less accumulated depreciation (or amortization or depletion) or impairment recognized to that point in time.

Replacement cost of an asset is defined as the amount of cash (or other sacrifice) that would be required on the valuation date to obtain the same asset, where the "same asset" is either an identical asset or an asset with equivalent productive capacity (i.e., the same probable future economic benefits). On the other hand, an asset's current market value is the amount of cash (or equivalent) that could be obtained on the valuation date by selling the asset "as is" in an orderly (unforced) liquidation. This value is most often tied to a quoted market price for the sale of a similar asset—assuming a market for the asset exists.

The net realizable value of an asset is defined as the amount of cash (or equivalent) into which the asset is expected to be converted in the ordinary operations of the business, reduced by any expected conversion costs, such as completion or disposal costs. Net realizable value is based on expected future proceeds, while current market value is based on current disposal value. The present value of an asset differs from its net realizable value in that the former considers the time value of money while the latter does not. The present value of an asset is computed by subtracting expected discounted future cash outflows from expected discounted future cash inflows.

<u>Cost of Intangible Asset</u>

SFAS No. 142 identifies and describes four classifications of intangible assets and the method of determining the intangible asset's cost under each classification, as follows:

- Purchased identifiable intangible asset (e.g., patent, trademark);
- Purchased unidentifiable intangible asset (goodwill);
- Internally developed identifiable intangible asset (e.g., patent); and
- Internally developed unidentifiable intangible asset (e.g., employee training).

Following GASB's sixth principle of government financial reporting, the basic valuation for capital assets is historical cost plus any ancillary cost to place the asset into use, while donated capital assets are reported at fair value. Although historical cost is in keeping with GAAP's framework of conservatism, paragraph 8 of SFAS No. 142 states that intangibles should be initially recognized and measured at fair value. Will GASB follow FASB's lead on this matter and depart from historical cost?

Amortization

The concepts of depreciation, depletion, and amortization are the same; as the physical or economic life of an asset diminishes, so too does the value of the related asset. Depreciation and depletion are associated with the physical or economic deterioration of plant assets and the removal of natural resources, respectively. Amortization is associated with the expiration of rights to current and future benefits.

Unlike fixed assets and natural resources, intangible assets are not physical in nature. Because of this lack of physical existence, the life of intangibles and the degree of future benefits are often uncertain. Amortization is usually on a straight-line basis over the useful life of the asset (not to exceed forty years), with a residual value of zero. Per SFAS 142, identifiable intangible assets with indefinite useful economic lives supported by clearly identifiable cash flows are not subject to regular periodic amortization. Instead, such assets are tested at least annually for impairment and an impairment loss is recognized when the carrying value exceeds the fair value. Furthermore, certain identifiable intangible assets must be amortized over their expected useful economic life, even if that life exceeds forty years.

Recognition

Acquired intangible assets other than goodwill are recognized when (a) control over the future economic benefits of the asset is obtained through contractual or other legal rights, or (b) the asset can be sold, transferred, licensed, rented, or exchanged. The intent of the acquirer is irrelevant. Per SFAS 142, contract-based intangibles have a fixed or definite life and include many kinds of agreements, contracts, covenants, easements, leases, permits, and other rights such as landing, lease, and mineral rights. Technology-based intangibles are defined as internal innovations or technological advances and include computer software and license, computer programs, and technological know-how. The FASB has concluded that exchangeability is a useful criterion for evaluating the nature of intangible assets; specifically, those intangible assets that can be sold or exchanged (transferred) represent “a potential source of cash flow” and as such merit recognition (SFAS 142).

Financial Statement Presentation

GASB Statement 34 sets out standards for reporting general capital assets and for note disclosures. General capital assets are to be reported in the governmental activities column of the government-wide Statement of Net Assets. In addition, the notes to the basic financial statements must present detailed information about the general capital assets in a format that clearly separates governmental assets from business-type activities assets. This information includes beginning balances, acquisitions, sales or other dispositions, ending balances, and current period depreciation expense. Capital assets not being depreciated are reported separately.

Intangible assets are not addressed in GASB Statement 34. However, governments use computers for an ever-widening range of uses, from internal accounting and information management to traffic flow regulation, reading of utility meters, and dispatching of emergency personnel. The software that governments purchase is accounted for as long-lived assets and is depreciated, but much of the software that governments use is internally developed and is expensed during development. The value of internally generated software, therefore, is not currently recognized in the financial statements of the reporting entity.

Implications for Reporting Government Intangible Assets

Presently, the reporting of intangible assets for government entities is to be accomplished as described in the following consolidation and summary of the authoritative pronouncements that address intangible assets (albeit with limited guidance).

Intangible assets held by a government are to be capitalized if they have a value greater than the minimum value above which the government's policy requires capitalization. The intangibles should be reported at their original cost, if available, or at market value at the time of their recognition in the accounts, if historical cost is not available. They should be amortized over their expected useful lives. If there is sufficient evidence to suggest that the assets will be productive for more than forty years, then the intangibles are not to be amortized but instead are to be reviewed annually to determine if impairment has occurred. Any impairment of intangible assets should be recorded and reported in the year in which the impairment is deemed to have occurred.

Implications for Future Research

The authoritative pronouncements offer scarce guidance to address the unique features of the kinds of intangibles considered here. Consider these three examples. First, singular control is granted to a government-owned and -operated airport that has "air rights;" at what value should such control be recorded? Second, potential value accrues to a city if it develops software applications that manage all of its traffic lights; should the costs of development be expensed or capitalized? If such applications increase the efficiency and volume of traffic flow, at what value might the expected future benefit of increased tourism, for example, be recorded? Finally, cost savings are anticipated for Federal, state, and local governments that use any of the many software applications generally described by the term "e-government." Should significant, probable, recurring increases in net cash flow be considered an intangible asset subject to identification, measurement, recognition, and reporting?

Further research is needed to determine the significance of intangible assets from the perspective of recognition and reporting. For instance, if governments do identify the existence of intangible assets, and if valuation of the intangibles renders them "immaterial," then their cost can be charged to expense (or expenditure) as the cost is incurred. On the other hand, if governments identify intangible assets held, and their value is material, then guidance is needed to record and report them appropriately. At present, there is no specific guidance about recording or reporting intangibles provided by GASB. In addition, a thorough examination of current practice can help standards setters as well as policy makers and government-wide financial statement preparers evaluate the scope of the intangible assets issue and the need to address the recognition and reporting of intangible assets.

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