



National Association of State Auditors, Comptrollers and Treasurers

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Mr. David Bean
Director of Research and Technical Activities
Project No. 9-4
Government Accounting Standards Board
401 Merritt 7
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Dear Mr. Bean:

On behalf of the National Association of State Auditors, Comptrollers and Treasurers, I am pleased to provide these comments about the Board's exposure draft, *Accounting and Financial Reporting for Intangible Assets*. Our members generally agree with the Board's approach and reasoning. We shall discuss the six issues which the Board asked that we address, and add to this letter some of the suggestions and questions from our members.

Issue 1

Our members agree with the characteristics which the Board believes are necessary to identify an intangible asset. One member observed that these characteristics "effectively narrow what should be captured as intangible assets." However, quite a few respondents found the phrase "nonfinancial in nature" to be ambiguous and confusing. Some of these members believe that this problem may be solved by bringing paragraph 29 in the Basis for Conclusions into the main standard, perhaps as a footnote. Others simply asked that the Board provide clarification as to the meaning of the term.

Issue 2

Our members agree with the Board's conclusion that intangible assets should be classified as capital assets and that the current guidance for capital assets should apply to intangible assets as well.

Issue 3

Our members agree with the specified-conditions approach to recognizing internally-generated intangible assets and the criteria listed by the GASB in paragraph 9 of the ED.

Issue 4

Our members agree with the approach that the GASB has outlined in paragraphs 10 – 15 for the recognition of outlays related to internally generated computer software as intangible assets. This approach is consistent with the AICPA's Statement of Position 98-1, which we believe many governments have already been using. One member mentioned that the guidance of SOP 98-1 is acceptable for billing the federal government for costs in internal service funds that are charged to federal grants.

Issue 5

Our members agree with the Board that there are some intangible assets with indefinite useful lives. They observe that if there is no decrease in an intangible asset's service capacity, then its carrying value should not be reduced. Our members also agree that if an intangible asset's useful life becomes finite, then it is appropriate to adjust its carrying value and amortize that amount over the estimated remaining useful life of the asset.

Issue 6

It appears that our members' attitudes towards the proposed transition provisions may best be described as, "Yes, but..." While a solid majority of our respondents agreed at least conceptually with the Board's conclusions in paragraphs 20 and 21 of the ED, many shared the concerns which a significant minority cited as cause for their opposition to the transition provisions.

Nearly half of our respondents had misgivings about or simply opposed retroactive reporting of intangible assets when the costs are unknown. Some indicated that attempting to determine or estimate the historical cost for internally generated intangible assets would not be cost-beneficial, as the useful lives of most of these assets (i.e., software) are uncertain and obsolescence will occur sooner or later. Other members indicated that historical costs were not available for many other intangible assets and that the effort to identify and value these assets would be overwhelming, especially for large governments. Members holding these views suggested that requiring prospective reporting only, or making retroactive reporting optional, would improve the ED considerably. Some members suggested that the difficulties of determining or estimating costs could be mitigated if the Board provided for intangible assets provisions similar to those in Statement No. 34 for infrastructure: (1) allowing a phase-in period depending upon the size of the government and (2) limiting the capitalization period to 20 years.

Our members provided a number of questions and suggestions which we believe may be of interest to the Board and which may improve the standard which is eventually issued. The questions and suggestions are listed in an attachment to this letter.

As always, we appreciate the opportunity to share our members' ideas and concerns about the GASB's due process documents. Should you have any questions about our comments, please feel free to contact me (jan.sylvis@state.tn.us or 615-741-2382) or Pat O'Connor or Sherri Rowland of the NASACT staff at 859-276-1147.

Sincerely,



Jan I. Sylvis
President

NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

Suggestions and questions related to the GASB's ED,
Accounting and Financial Reporting for Intangible Assets

Issue	Suggestions and Questions
Issue 1	We have concerns related to identifying and separating certain existing intangible assets. For example, if water, mineral, and/or timber rights were included with acquisitions of state land, we think that the effort necessary to separate these intangible assets would far outweigh any benefit derived from separate reporting. We suggest that separation not be required in these cases.
Issue 1	The state invests in non-development rights to preserve farmland, forests, access to recreational trails, etc. The state is making payments to land owners in exchange for guarantees that the land will be preserved for a specific purpose. This benefits the citizens of the state because urban sprawl is managed and forests and trails can continue to be enjoyed by the general public. However, titles to these tracts of land belong to others (individuals, local governments, private organizations). Can a government recognize an asset by investing in property owned by another party? According to GASB's proposed Concept Statement on elements, a resource that is preserved by the entity on behalf of the citizenry or general public qualifies as an asset. Non-development rights would seem to qualify as an asset under this definition, but this begs another question. Can a government recognize an asset by investing in another party's asset? Alternatively, should these investments be recognized as grant expenditures with no recognition of an intangible asset?
Issue 1	We suggest that additional information be added to clarify which government would report an intangible asset that is owned by one government but is being maintained by another government, for example, water rights or an easement owned by a state government being maintained by a local government. Given that "assets" are defined as "resources that the entity presently controls," we anticipate that questions will arise if one government believes it <i>controls</i> the asset, but the other government actually <i>owns</i> the asset. Is there an ownership requirement that needs to be met?
Issue 1	We suggest clarification of the word <i>nonfinancial</i> , which is defined in the Basis for Conclusions as assets that "are not expected to ultimately be settled in fixed or determinable amounts of cash, and do not reflect a prepayment of cash for goods or services". Paragraph 31 goes on to state, "Because assets held for sale are expected to ultimately be settled in cash, the Board concluded that these assets should <i>not</i> be considered to have a nonfinancial nature. Therefore, intangible assets held for sale do not meet the description of intangible assets as used in this proposed statement in paragraph 2." However, paragraph 7 states that "An intangible asset should be recognized in the statement of net assets only if it is identifiable, meaning that either: (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..." Paragraph 7 seems to indicate that intangible assets can be settled in cash. We understand the difference between "capable of being sold" and "expected to be sold"; however, we believe that it would be clearer if <i>nonfinancial</i> were defined within the standard, preferably in the recognition section, instead of in the Basis for Conclusions. By defining this term alongside the related requirement, in the standard, we believe that a better understanding of the Board's intentions would be obtained.
Issue 2	The phrase "or in lieu of if appropriate" is likely to cause some confusion. It is unclear under which circumstances the authoritative guidance in this exposure draft would need to be applied <i>in lieu of</i> other authoritative guidance related to accounting and financial reporting of capital assets. Please clarify which circumstances might require the application of the guidance in the ED in lieu of other authoritative guidance.
Issue 2	We suggest that additional information could be provided on the acceptability of reporting tangible and intangible assets as part of the same major category of asset. For example, easement rights are sometimes acquired as part of a purchase of land. Would it be acceptable under current guidance to include easements as part of land in the note disclosure? Or should intangible assets be reported separately as their own major category?

Issue	Suggestions and Questions
Issue 3	We wonder if there will be occasions in which a government has met all but one of the criteria and only several years later meets the final criterion. In these cases, we can foresee implementation issues in determining which outlays should rightfully be included in the capitalized cost of the intangible assets. It would appear that the proposed standard, in these situations, would only allow a prospective capture of costs, perhaps severely understating the true "cost" or value of the asset. We believe that the board should consider the appropriate accounting treatment in these circumstances, which should include a discussion about accumulating the appropriate costs to capitalize, and provide guidance in the standards.
Issue 3	<p>We found that we fully understood and agreed with this provision only after reading the Basis for Conclusions. Some of those discussions explain why earlier recognition, or complete recognition, is not appropriate and why the criteria in paragraph 9 <i>are</i> appropriate. Therefore, we believe the following specific language in the Basis for Conclusions (edited as to how they could be included) should be brought into the standard as part of or immediately following paragraph 9:</p> <ul style="list-style-type: none"> • From paragraph 47: To explain that general development and similar costs should not be capitalized as intangible assets, language could be added to indicate that <i>capitalization is limited to only those outlays that directly relate to the creation of the specific intangible asset being developed through the project, excluding outlays that relate more to general research or the pursuit of varying alternative paths of development.</i> • From paragraph 48: To explain expected service capacity, language could be added to explain that a government's <i>existing and similarly created intangible assets indicate evidence that the asset will provide service capacity. In the absence of experience with similar intangible assets, management should have other evidence to indicate that the asset will achieve the expected nature of its service capacity.</i> • From paragraph 49: To explain technological feasibility, language could be added such as: <i>designing a path or course of action that, if executed properly, will result in an asset that will generate the expected service capacity, rather than outlays for the completion of general research.</i> • From paragraph 50: To explain a government's future commitment, language could be added to explain that <i>Evidence of intention, ability, and presence of effort to complete the intangible asset may include any formal government actions, such as budgetary commitments, strategic planning documents, commitments with external parties, and efforts to secure the government's legal rights to the project. As projects may take place over several years, a commitment to continue development of the intangible asset would suffice for meeting the specified conditions criteria if all of the other conditions are met.</i>
Issue 3	We suggest presentation of examples providing clarification with regard to the criterion described in paragraph 9c, demonstration of the technical or technological feasibility for completing the project so that the asset will provide its expected service capacity. It was not immediately clear how the records of a government would provide such a demonstration. The example provided in Appendix C does not appear to specifically address this criterion; accordingly, we request the example be revised to do so.
Issue 3	In the last sentence of paragraph 9, this guidance appears to relate to a preliminary project stage based on a specified conditions approach. This makes sense when paragraph 11 is read. We believe that the two paragraphs be linked somehow (e.g., the way that paragraph 12 refers to paragraph 9).
Issue 3	We believe that the board should provide additional guidance and explanations in the body of the standard regarding application of the specified-conditions approach. Specifically, we believe that the board needs to provide the definition of service capacity in the body of the statement as opposed to the Basis for Conclusions.
Issue 3	We are having trouble relating condition <i>b</i> to actual practice. How specific should this determination be?
Issue 3	For internally generated intangible asset projects that take place over two or more accounting periods, guidance should be given as to how the outlays should be reported until the project is complete. How will a reader of the financial statements be able to distinguish between intangible assets which are in the process of being developed from intangible assets which are not amortized (due to an indefinite useful life)? Should an asset similar to construction in process be reported in the financial statements to capture these outlays as they are incurred?
Issue 4	In regard to paragraph 11, the board should consider providing a clearer dividing line among the different stages of project development. For example, when does implementation of computer software end (capitalization) and expensing activities begin (i.e., post-implementation/operation stage)? Also in paragraph 11b, the board should consider clarifying that the parallel processing phase should include data conversion and testing should be successful before exiting this stage.

Issue	Suggestions and Questions
Issue 4	We recommend that internally generated software be treated like other capital assets in considering if a modification which extends its useful life should be capitalized or considered maintenance. We do not agree that <u>only</u> modifications which increase capacity or efficiency should be capitalized. We believe modifications to software which significantly extend the life of the software should be capitalized even if they do not increase efficiency or capacity. The modifications made on many computer systems to deal with Y2K limitations several years ago would be an example. We do not think internally generated software needs to be treated differently than capital assets such as buildings. Major renovation work on a building which extended its useful life but did not increase capacity or efficiency would be capitalized. The GASB's assertion that these types of modifications are maintenance costs and that the extension of the useful life is a sign of a bad original estimate for a useful life seems improper. This argument gives no consideration to the type or significance of those modifications.
Issue 4	Many software development projects also include a process re-engineering component. In many cases, re-engineering of current methodologies is between 50% and 80% of the total project cost. Governmental entities must undergo process re-engineering to take advantage of commercially developed computer software. Process re-engineering is a critical part of the project cost; however, it is not included in any of the stages discussed in paragraph 11. Further, the board has not provided guidance as to whether costs associated with process re-engineering are a component of the capital asset value or an operating cost of the new method of doing business. Such guidance should be provided.
Issue 4	We believe that it may be difficult to differentiate the difference between maintenance or an upgrade or modification that would warrant capitalization. Therefore, we believe that all costs that occur after the post implementation/operation stage should be expensed as incurred.
Issue 4	We believe that the board should consider proposing additional guidance in the area of internally developed computer software. The rapid pace of technological change affects this type of asset in a way that makes it distinguishable from other intangible assets. In many cases, from an organizational viewpoint, the development process, from creation of a baseline application through subsequent enhancements and modifications over the life of the application, is more of a continuum than a set of discrete events. We suspect that applying the proposed standard, as written will result in a great deal of variation in its implementation.
Issue 4	We believe that there is a great need to add more detail about the costs that are to be capitalized. AICPA <i>Statement of Position 98-1, Paragraph .31 and .33</i> appear to offer more guidance on the capitalizable costs. With the addition for more detail and examples, a great deal of confusion could be avoided and a more consistent level of reporting among different governments would be created.
Issue 4	We think that there are two types of training costs and that these costs should be recognized differently – training of user staff about how to process various transactions within the software and training of entities' development staff by the software vendors about how to configure the software in order to be able to accommodate the various transactions. We believe there is a fundamental difference between these training costs and that the costs of training the entities development staff are proper capitalizable costs of developing the application and getting the project to the point where it is substantially complete and ready for its intended use. Without the staff gaining this critical knowledge of the inner workings of the software package, the project would not be able to progress to completion. User training is not necessary to get to this point and more than likely occurs in the post implementation stage, and is therefore appropriately expensed.
Issue 5	We believe that applying GASB 42 to intangible assets could be difficult, especially applying the indicators of impairment. We would like clarification/confirmation of GASB 42, paragraph 8, which requires impairment events to be conspicuous (meaning that governments need not perform additional procedures to search for impaired intangible assets).
Issue 6	We believe that the phrase "after making every reasonable effort" needs further clarification due to its subjectivity. Maybe, just stating that professional judgment should be used would suffice, as well, even though it is subjective too.

Issue	Suggestions and Questions
Issue 6	<p>We are concerned about the process of recognizing and valuing easements and recommend that GASB provide more guidance for recognition and valuation of easements. Some governments believe that an easement has been established when a master plan is created showing future locations of roads, utilities, etc. While no development has taken place they have created a restriction or easement on the use of those lands where future infrastructure will be. This easement would seem to meet the criteria of paragraph 7 for recognition. However, if this easement is considered internally generated it would not yet meet all of the criteria of paragraph 9. To complicate this example, the actual development might not conform to the original master plan. The original easements are often changed by the approval of the final development. These factors complicate the timing of recognition.</p> <p>The valuation of an easement is complicated by its type. While road right-of-ways are fairly easy to value, a utility easement is not. Since a utility easement has less effect on the use of the land, establishing a value can be difficult.</p>
Issue 6	<p>Neither this statement nor the supporting language in the Basis for Conclusions adequately defines "every reasonable effort." No time limits or options for cost/benefit analysis are included. For example, if it is determined that the cost to determine the historical amount is excessive, would that be reason enough not to go forward with the determination or would that be evidence that the determination could be made and therefore should be done?</p>
Issue 6	<p>In the last sentence of paragraph 20, does the disclosure guidance apply to the cumulative effect change of beginning net assets? Please clarify.</p>
General comments	<p>Overall, we found that the guidance embodied in this document does not apply to conditions existing or emerging in today's governmental environment. This statement primarily addresses traditional government operations and not some of the more complex emerging activities and relationships that often result in intangible assets such as those used by higher education institutions and other governmental entities. We believe the board should expand the standard to include guidance on the following issues to ensure consistency in reporting as they are becoming more prevalent in government operations.</p> <ul style="list-style-type: none"> • Many governments are now using public private partnerships or arrangements resulting in joint ownership in the development of intangible assets. For example, two separate governmental entities may share in the development of computer software. The exposure draft currently does not address situations in which there is joint ownership of intangible assets. • The example and discussion of computer system applications followed a historically traditional system development effort. Most modern systems development efforts do not result in the ownership of software, but instead represent minimal cost to modify or enhance the application and significant cost in analyzing and then re-engineering the processes. On some enterprise applications, the software licenses and related modifications may represent less than 20% of the project's total cost. However, the remaining 80% represents re-engineering, which are changes in business processes. The exposure draft does not address this system development effort, which represents most system application projects today. • Governmental entities may transfer ownership or rights to an intangible asset to another entity. For example, higher education institutions often enter into arrangements where they assign the rights to patents and copyrights to their foundations or other sponsoring organization. The exposure draft does not address how governments should report these transactions in their financial statements. • Governmental entities may conduct research and development efforts without the intention of creating an intangible asset. Further, it may take many years before it is evident that a capitalizable intangible asset exists. Is it the intention of the board that governmental entities keep detailed records of all of the direct and indirect costs incurred in research and development efforts so that if it results in a patent or copyright they will have the information necessary to record the value? Further, the exposure draft does not address whether governments will be required to restate financial statements if they determine several years into the project that an intangible asset exists or whether there will be a requirement to record an asset similar to construction in progress for a multi-year project. • The exposure draft does not address some of the more complex easement arrangements involving governments, such as open air easements where there is no direct ownership. Further, by not including any guidance on the factors governments should consider when estimating the fair value of easements, we believe there will be additional inconsistencies among governments in recording these assets.

Issue	Suggestions and Questions
General comments	We believe that the GASB needs to provide additional guidance on reporting for patents. The fair values of patents have the potential of being extremely volatile due to changes in technology and could create potentially significant impairment losses. For this reason, we believe that patents should be expensed versus being shown as an asset on the balance sheet.
General comments	Currently, if natural resources such as timber or water rights have been purchased, they have been capitalized as part of the cost of land. To have to reclassify these costs from land to intangible assets would require considerable time and effort on the part of the state. The total historical cost of capital assets reported on the state's financial report is correct as it is currently reported. It is our opinion that performing this reclassification would not provide the user any further information or clarification. In addition, we question the inclusion of water and timber rights but no mention of mineral rights.
General comments	Paragraph 7 of the ED states that an intangible asset should be recognized only if it is separable or arises from contractual or other legal rights. Would an entity have to be able to sell (separate) internally generated computer software in order to capitalize it? What if the software was specific to the entity's needs and there was no market for it? Would the entity still capitalize the software as an intangible asset?
General comments	The term " <i>internally generated</i> " in paragraph 8 implies assets that are created or produced in-house by the government. Therefore, the term " <i>internally generated</i> " intangible assets is somewhat confusing until the definition in paragraph 8 explains that it includes "intangible assets that are created or produced by the government or an entity contracted by the government, and intangible assets that are acquired from a third party." We believe that it would be less confusing to simply say "intangible assets that are developed or obtained for internal use."
General comments	The standard should specifically address the stage in which software licensing should be placed and distinguish among different types of software licensing in doing so. Although SOP 98-1 and FASAB Statement 10 (paragraphs 66-67) both address this issue, the guidance is confusing. SOP 98-1, paragraph .32 provides that capitalization of software licensing should consider the concepts in FASB Statement 13, "Entities often license internal-use software from third parties. Though FASB Statement No. 13, <i>Accounting for Leases</i> , excludes licensing agreements from its scope, entities should analogize to the Statement when determining the asset acquired in a software licensing arrangement." Does this provision refer to the capitalization criteria for leases or to recording the asset at the present value of the minimum stream of payments (when license agreements require periodic payments)? The latter makes more sense than the former.
General comments	Since many large state software programs are paid in large part by the federal government, we believe that the ED should address ownership and residual rights exercised by the federal government over software. The ED also does not contemplate the practice of the federal government paying for a complete software implementation only in one or two pilot states. Once the federal government has funded the pilots, the remaining states are expected to use and modify the pilot state's software. Does that mean that the subsequent states should only capitalize the modification costs, or does a donated asset exist?
General comments	Does the requirement of paragraph 21 that governments should disclose the nature of the internally generated intangible assets and the fact that they have not been recognized in the statement of net assets apply to all periods after which the Statement is first applied or just the first period the Statement is applied? Should the requirement be, "In this case, <u>beginning with</u> the financial statements of the period,?"
General comments	In Example 3 under the discussion of recognition, the ED states, "These outlays would be recorded as capital outlay expenditures in the 2013 general fund statement of revenues, expenditures and changes in fund balance." It is our understanding that the capital outlay classification is not generally associated with the general fund and is usually reserved for the capital projects fund. Is the Board suggesting that capital outlays now be reported as an expenditure classification for governmental funds other than capital project funds? This potential change in classification does not appear to be discussed either in the proposed standard or in the basis for conclusions. We would not agree with this suggestion and believe that capital outlays should remain reserved for capital projects funds. Please provide clarification.