BUDGET LETTER

SUBJECT:	CAPITALIZATION OF INTANGIBLE ASSETS	**NUMBER:**	10-13
		DATE ISSUED:	June 18, 2010
REFERENCES:	STATE ADMINISTRATIVE MANUAL SECTIONS 8601, 8602, 8602.2, 8603, 8611, 8615, 8615.1, AND 8617 ET SEQ.	**SUPERSEDES:**	

TO: Agency Secretaries
Department Directors
Departmental Budget Officers
Departmental Accounting Officers
Department of Finance Budget Staff
Departmental Information Technology Officers
Department Business Services

FROM: DEPARTMENT OF FINANCE

This Budget Letter (BL) notifies departments of new accounting and reporting requirements for intangible assets effective for fiscal year 2009-10. The change in policy is needed to comply with Governmental Accounting Standards Board Statement No. 51 (GASB 51)—*Accounting and Financial Reporting for Intangible Assets*. State Administrative Manual sections 8615 and 8615.1 previously defined intangible assets and the capitalization criteria for them. The new policy requires capitalization of not only purchased intangible assets, but also internally generated intangible assets. The new policy includes additional general ledger accounts (GLAs) to separate the types of intangible assets and provides more description of the types of intangible assets. The following is a summary of the new accounting and reporting requirements for intangible assets. After the policy summary, specific information for implementing the new policy in 2009-10 is provided, including guidelines for retroactively reporting intangible assets that were not previously reported.

NEW POLICY

Tangible and intangible assets must be capitalized and recorded in an asset GLA if they meet the following criteria:

- Have an expected useful life of at least one year,
- Have a cost of at least $5,000, and
- Are used to conduct state business.

Definition of an Intangible Asset

An intangible asset is an asset that possesses *all* of the following characteristics:

a. Lacks physical substance. It may be contained in or on an item with physical substance (for example, software stored on a compact disc) or it may be closely associated with another item that has physical substance (for example, the underlying land in the case of right-of-way easement).
b. Is nonfinancial in nature (not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods and services).

c. Is identifiable. An intangible asset is considered identifiable when either of the following conditions are met:

    - The asset is separable; that is, the asset is capable of being separated or divided from the department and sold, transferred, licensed, rented, or 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 department or from other rights and obligations.

Examples of intangible assets include:

- Computer software and websites.
- Land use rights, such as right-of-way easements, water rights, timber rights, and mineral rights.
- Patents, copyrights, and trademarks.

Land use rights associated with property already owned by the government are considered part of the land and should not be reported as intangible assets. In contrast, land use rights that were acquired in a transaction that did not involve acquiring the underlying property should be reported as intangible assets.

Intangible assets can be purchased, including acquisition through an installment purchase contract; acquired through licensing agreement; acquired through non-exchange transaction, such as donation; or internally generated.

Exceptions

Three types of intangible assets are *excluded* from the policy:

- Intangible assets acquired or created primarily for directly obtaining income or profit. These assets should be recorded as an investment.
- Assets resulting from capital lease transactions reported by lessees.
- Goodwill created through the combination of another entity and a state department.

Internally Generated Intangible Assets

Intangible assets are considered internally generated if they are created or produced by a department or an entity contracted by the department, or if they are acquired from a third party but require more than minimal incremental effort on the part of the department to achieve their expected level of service capacity.

Outlays incurred in the development of an internally generated intangible asset that are identifiable should be capitalized only upon the occurrence of all of the following:

a. 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 the completion of the project.
b. Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity.
c. 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.

Only outlays incurred subsequent to meeting the above criteria should be capitalized. Outlays incurred prior to meeting those criteria should be expensed as incurred.

Internally Generated Computer Software

Computer software is a type of intangible asset that is often internally generated. During the development stage, evaluate the expenditures to determine whether capitalization appears appropriate. Record the applicable capitalizable expenditures as Internally Generated Intangible Assets in Progress, GLA 2430.

Commercially available software purchased or licensed by a department that requires modification using “more than incremental effort” before being put into operation should be considered internally generated. For example, licensed financial accounting software that the department modifies to provide special reporting capabilities would be considered internally generated.

The activities involved in developing and installing internally generated computer software can be grouped into the following stages:

Preliminary Project Stage—Costs incurred during this stage are not capitalized.

These costs include the following activities:

a. Conceptual formulation of alternatives.
b. Evaluation of alternatives.
c. Determination of existence of needed technology.
d. Final selection of alternatives for development.

Application Development Stage—Costs incurred during this stage involve both internal and external costs incurred to develop the software and are capitalized.

These costs include the following activities:

a. Design of chosen path, including software configuration & software interfaces.
b. Coding.
c. Installation to hardware.
d. Testing, including the parallel processing phase.
e. Data conversion—only to the extent that the data is necessary to make the computer software operational.

Post-Implementation/Operation Stage—Costs incurred during this stage are not capitalized.

These costs include the following:

a. Training.
b. Application maintenance.
c. Data conversion—data, such as historical, not necessary to make the software operational, but desirable from a management perspective.

For internally generated computer software, the criteria listed under Internally Generated Intangible Assets on page two should be considered to be met only when both the following occur:

a. The activities noted in the Preliminary Project Stage are completed.
b. Management implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multiyear project, the software development project.

Once the criteria for internally generated intangible assets have been met, outlays related to activities in the Application Development Stage should be capitalized. Capitalization of such outlays should cease no later than the point at which the computer software is substantially complete and operational. Outlays associated with activities in the Post-Implementation/Operation Stage should be expensed as incurred.

Internally Generated Modification of Computer Software

Outlays associated with an internally generated modification of software that is already in operation should be capitalized when all internally generated software intangible assets criteria have been met if the modification results in any of the following:

a. An increase in the functionality of the computer software; that is, the computer software is able to perform tasks that it was previously incapable of performing.
b. An increase in the efficiency of the computer software; that is, an increase in the level of service provided by the computer software (e.g., increased speed, making the software more user-friendly, increased capacity for number of users) without the ability to perform additional tasks.
c. An extension of the estimated useful life of the software.

If the modification does not result in any of the above outcomes, the modification should be considered maintenance, and the associated outlays should be expensed as incurred.

Useful Life and Amortization

Intangible assets are amortized over the useful life of the asset. The useful life of an intangible asset that arises from contractual or legal rights should not exceed the legal term of the rights. Renewal periods should be considered in determining the useful life if the department plans to seek a renewal and the anticipated costs of the renewal are nominal in relation to the level of service capacity expected to be obtained through the renewal. Otherwise, the department must account for the renewal as a replacement of the old intangible asset with a new intangible asset.

An intangible asset should be considered to have an indefinite useful life if there are no legal, contractual, regulatory, technological, or other factors that limit the useful life of the asset. A permanent right-of-way easement is an example of an intangible asset with an indefinite useful life. Intangible assets with an indefinite useful life are classified as non-amortizable. Computer software *does not* have an indefinite useful life. Generally, amortization is performed only by those non-governmental cost funds, such as Public Service Enterprise Funds, and Working Capital and Revolving Funds, that conduct enterprise or internal service fund operations.

New General Ledger Accounts

Previously, intangible assets were recorded in GLA 2410—Intangible Assets and GLA 2490—Accumulated Amortization – Intangible Assets. To meet the new reporting requirements, new GLAs have been added to the Uniform Codes Manual as follows:

GLA Title

2410 Intangible Assets – Amortizable
- 2411 Computer Software – Amortizable
- 2412 Land Use Rights – Amortizable
- 2413 Patents, Copyrights, Trademarks – Amortizable
- 2414 Other Intangible Assets – Amortizable

2420 Intangible Assets – Non-Amortizable
- 2422 Land Use Rights – Non-Amortizable
- 2423 Patents, Copyrights, Trademark – Non-Amortizable
- 2424 Other Intangible Assets – Non-Amortizable

2430 Internally Generated Intangible Assets in Progress

2490 Accumulated Amortization – Intangible Assets
- 2491 Accumulated Amortization – Computer Software
- 2492 Accumulated Amortization – Land Use Rights
- 2493 Accumulated Amortization – Patents, Copyrights, Trademarks
- 2494 Accumulated Amortization – Other Intangible Assets

Suggested journal entries to record intangible assets are attached (Attachment I).

FISCAL YEAR 2009-10 IMPLEMENTATION OF NEW POLICY

Departments are required to comply with the new intangible asset policy in their financial statements submitted to the State Controller's Office (SCO) beginning with 2009-10. However, since this is the first year of implementation, we are providing some additional guidance for 2009-10.

Retroactive Reporting of Unrecorded Intangible Assets

Retroactive reporting for previously unrecorded intangible assets acquired prior to July 1, 2009, is required when all of the following conditions have been met:

a. The intangible asset is in use as of July 1, 2009, and will continue to be used for some future period of time.
b. The department has never reported the intangible asset in Reports 18 and 19 (for governmental cost and bond funds) or in their fund financial statements (for non-governmental cost funds, other than bond funds) in any prior period.
c. The historical/acquisition cost of the intangible asset is $1 million or above.

Intangible assets in use as of July 1, 2009 that are identified as **having an indefinite useful life** or were **internally generated** are ***not*** required to be retroactively reported.

Use the following guidelines for age and value in identifying which intangible assets to retroactively report. If the actual historical cost of the intangible assets cannot be determined, departments should report an estimated historical cost. Donated intangible assets should be recorded at their fair value on the date the gift was received. Keep detailed records of the method used in determining the value of **retroactively reported intangible assets** for audit purposes.

Asset Type	**Dates Purchased**	**Acquisition Cost (per item)**
Computer Software & Websites	7/1/2000 thru 6/30/2009	$1,000,000
Land Use Rights	7/1/2000 thru 6/30/2009	$1,000,000
Patents, Copyrights, and Trademarks	7/1/1990 thru 6/30/2009	$1,000,000
Other Intangible Assets	7/1/2000 thru 6/30/2009	$1,000,000

For **governmental cost and bond funds,** use the current Report 18—Statement of Changes in General Fixed Assets and Report 19—Statement of General Fixed Assets format to report the historical/acquisition cost of intangible assets along with other capital assets using the new intangible asset GLAs. The beginning fund balances should be restated to include the intangible assets in existence prior to July 1, 2009, but not previously reported. Also, reclassifications of intangible assets previously reported in GLA 2410 to the new intangible asset GLAs should be shown in the beginning balances. The addition column should only be used for assets acquired or internally generated during 2009-10. Departments are not required to calculate or report accumulated amortization on these retroactively reported intangible assets. The SCO performs all depreciation and amortization calculations centrally for all governmental cost and bond fund capital assets. Departments may choose to submit the Report 18 using the attached Excel worksheet (Attachment II).

For **non-governmental cost funds (except for bond funds),** departments are required to calculate and report all intangible asset balances, accumulated amortization, amortization expense, and the net effect to beginning fund balance of retroactively reported intangible assets in their fund financial statements. No amortization is needed for intangible assets having an indefinite useful life. Reclassifications of intangible assets previously reported in GLA 2410 to the new intangible asset GLAs do not affect beginning fund balance. Keep detailed records for all calculations relating to accumulated amortization and beginning fund balance restatement for audit purposes. Also, departments should footnote the year-end reports with the reason for their beginning fund balance restatement.

Reporting of Intangible Assets Acquired or Developed after July 1, 2009

For intangible assets acquired or developed after July 1, 2009, the capitalization threshold is $5,000. The threshold determination should be based on the individual item rather than the aggregate cost. For example, if a department purchases 100 copies of a software license for $150 each, even though the total cost exceeds $5,000, the department should not capitalize the software since the software license costs less than $5,000 each.

For internally generated intangible assets, departments are **required** to track and capitalize all direct and indirect asset development costs incurred since July 1, 2009. If the department chooses to retroactively report the asset development costs incurred prior to July 1, 2009, the department can only capitalize the costs incurred during the asset development stage of the project. Costs incurred during the preliminary project stage and post implementation/operation stage are expensed as incurred. If the intangible asset is not fully developed by June 30, 2010, the accumulated cost of developing the intangible assets is reported in GLA 2430—Internally Generated Intangible Assets in Progress. No amortization is taken for assets in progress. Once the asset is completed, it is reclassified to the appropriate intangible asset type and amortization begins.

If you have questions regarding this BL, please contact the Fiscal Systems and Consulting Unit hotline at (916) 324-0385 or e-mail: fscuhotline@dof.ca.gov. If you have questions regarding 2009-10 financial statement requirements, please contact the SCO at stategovreports@sco.ca.gov or (916) 322-6873.

/s/ Veronica Chung-Ng

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Program Budget Manager

Attachment