RICHEY MAY & CO

# Accounting for Software

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The following white paper provides guidance on accounting for internally developed software for both internal use and sale to outside parties.

# Accounting for Software

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## Overview

Today's market driven technology is revolutionizing the way products are delivered to consumers. Many in the mortgage banking industry are expecting the traditional process of obtaining a loan to evolve through the use of technologies as lenders look to reduce costs and increase efficiencies without jeopardizing quality. The development of software, including mobile applications, is becoming popular among companies looking to provide cutting-edge technology in order to increase market shares and profitability. But the accounting for internally developed software for internal use or sale to outside parties is typically an afterthought, and the ramifications of incorrectly accounting for software can be costly.

Many entities develop software that will be internally used or sold to others. The Financial Accounting Standards Board (FASB) has separated these into two separate Accounting Standard Codifications (ASC): ASC 350-40, *Intangibles – Goodwill and Other – Internal-Use Software* and ASC 985-20, *Accounting for the Costs of Software to be Sold, Leased, or Marketed*. It is vital that management understands the purpose the software will serve prior to completion due to the differences in revenue recognition and capitalization requirements under these two standards.

## Internal-Use Software

There are two conditions that need to be met to determine whether the software is for internal use. Firstly, the software is acquired, internally developed or modified solely to meet the entity's needs. And secondly, during the software's development or modification, no substantive plan exists or is being developed to market the software externally. When a company elects to capitalize costs of computer software developed or obtained for internal use, the company will follow ASC 350-40 to determine what expenses can be capitalized or need to be expensed as incurred. There are three stages in which internal use software will be classified during development that will guide companies in determining the capitalization of expenses: (1) the preliminary or research stage; (2) the application stage; and (3) the post-implementation-operation stage. Capitalization can only begin once the preliminary project or research stage has been completed and management has authorized and committed to funding the project, once it is probable that the project will be completed and when the software will be used to perform the function intended. Capitalization will end once the project is substantially complete and ready for intended use.

Below is a breakdown of the three stages:

### *Preliminary Project or Research Stage*

Internal and external costs incurred during the preliminary project stage are required to be expensed as incurred. Examples of the preliminary stage of the project include making strategic decisions to allocate the resources between alternative projects, training and maintenance costs, determining the performance requirements, vendor demonstrations, determining the technology needed and consulting.

### *Application Development Stage*

Applicable internal and external costs incurred to develop or obtain internal use computer software to meet an entity's internal needs are allowed to be capitalized. Examples of costs allowed to be capitalized are external direct costs of material, payroll and related costs for employees who devote time to and are directly associated with the projects, interest costs incurred while developing internal use software and costs of enhancements or updates of the system (if it's probable the enhancement or upgrades will result in additional functionality). Additionally, any costs to develop or obtain software that allows for access to or conversion of old data by new systems can also be capitalized. However, any costs associated with training during this stage, as well as the actual costs of conversion, are to be expensed.

### *Post Implementation – Operation Stage*

Internal and external training costs and maintenance costs are required to be expensed as incurred. Once the software is ready to be implemented, capitalization will cease and the software will begin to be amortized.

## Amortization of Internally Developed Software

Once the project has been completed and the software is in use, the capitalized costs are required to be amortized, typically on a straight-line basis. When determining the useful life of the asset, entities should consider the effects of obsolescence, technology and competition. Given the history of rapid changes in technology, software often has a relatively short useful life.

## What if a company decides to market their software during development?

As previously mentioned, it is important to understand the purposes of the software during the preliminary stages as well as prior to completion. However, sometimes companies decide during the development stages that their software will no longer be strictly for internal purposes and can also be sold to others.

When a company decides that their internally developed software will no longer be used strictly for internal purposes, the company will stop following ASC 350-40 and follow ASC 985-20, *Accounting for the Costs of Software to be Sold, Leased, or Marketed*, which will be discussed later. When switching from internal use only to selling to others, it is important to make this switch prior to completion.

### What if a company decides to market their software after completion?

If a company decides to market their software after completion, the proceeds received from the license of computer software (net of direct costs) will be applied against the carrying value of the software on the balance sheet prior to any revenue being recognized on the income statement. No profit will be recognized until the aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero.

## Internally Developed Software to be Sold, Leased or Marketed

When the entity is developing software to be sold, leased or marketed, management needs to understand the difference in accounting between software being developed for internal use and that being sold externally. The timeline of when expenses can be capitalized is similar to ASC 350-40, but the application of expenses being capitalized can vary significantly.

All costs incurred to establish the technological feasibility, which is similar to the application development stage noted above, are to be expensed as incurred. Technological feasibility is established when the entity has completed planning, designing, coding and testing activities that are necessary to establish that the software can be produced to meet its design specifications and technical performance requirements. At a minimum, the company will perform the following two activities in order to determine if technological feasibility has been established:

1. If the process of creating a software product includes a detail program design, the following need to be met:
    a. The product design and the detail program design have been completed and the entity has established that the necessary skills, hardware and software technology are available to produce the software.
    b. The completeness of the detail program design and its consistency with the product design have been confirmed by documenting and tracing the detail program design to product specifications.
    c. The detail program design has been reviewed for high-risk development issues and any uncertainties related to identified high-risk development issues have been resolved through coding and testing.

2. If the process of creating a software product does not include a detail program design, the following needs to be met:
    a. A product design and a working model of the software product have been completed.
    b. The completeness of the working model and its consistency with the product design have been confirmed by testing.

### What can be capitalized once technological feasibility has been established?

Once an entity has established and proven that the technological feasibility stages have been established and all research and development activities for other components of the software is complete, the entity will begin to capitalize costs of producing the software, such as coding and testing. The entity may also capitalize an allocated amount of indirect costs related to individuals who are directly associated with the product. However, an allocation of general and administrative expenses is not allowed due to these costs being related to the period in which they are incurred.

### When to stop capitalizing and start amortizing?

Once the software product is available for general release, the entity will stop capitalizing costs. Costs of maintenance and customer support will be expensed when the related revenue is recognized or when these costs are incurred, whichever occurs first. Once the product is available for general release and capitalization has ceased, the entity will start amortizing the capitalized amounts off the balance sheet and into the income statement. Amortization will be based on the greater of the percentage of revenue or straight-line method over the remaining estimated economic life. Each balance sheet date, the entity will compare the unamortized capitalized costs to the net realizable value of the product to determine impairment.

## Purchased Computer Software

Some entities prefer to purchase software as an alternative to developing internally and subsequently modify or integrate purchased software with another product or process. The entity can capitalize the total cost of purchased software that has no alternative future use if certain conditions are met at the time of purchase. If conditions are not met at the date of purchase, the total cost will be expensed as research and development. For example, if software is purchased to be integrated with another product or process, the cost may be capitalized only if technological feasibility is established for the software component and all research and development activities for the other components are complete.

If purchased software has an alternative future use, the cost shall be capitalized when the software is acquired and accounted for in accordance with its use.

## How can you prepare now?

We recommend that mortgage companies in consideration of developing their own software reach out to Richey May & Co. for additional guidance and help.

*Notice to Reader:*