TBH Consulting LLC

Software Development Costs

Executive Summary

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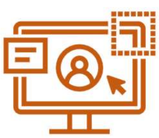
I. Overview: Software Development Costs

Software in business

As technology continues to advance, most companies experience software development in some capacity, whether building reliable and integrated software that can be used internally to improve operations or developing software to be sold or licensed to third parties. Software is a set of computer programs and associated documentation and data. Certain development costs for both types of software are to be capitalized in accordance with ASC 350-40 or ASC 985-20, respectively.

Internal-use software

Under ASC 350-40, internal use software is acquired, internally developed or modified and is utilized solely to meet the entity's internal needs and has no plan to be marketed externally. If the software possesses these characteristics, its development will be within the scope of ASC 350-40.



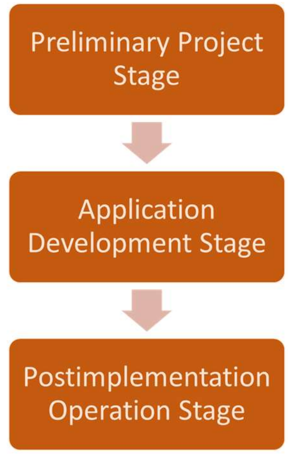
A plan to market the software externally, such as the development of marketing and billing activities, may indicate the software is not for internal use. If the software will ultimately be transferred to a customer, it will instead be accounted for as software to be sold, leased or marketed.

Software to be sold, leased or marketed

Software to be sold, leased or marketed is referred to as a software product. Under ASC 985-20, a software product is a set of programs that has been packaged for the purpose of marketing to third parties. It may be sold to either end users or distributors.

In order to be considered a software product, the software must be a set of programs that interact with each other, is complete and has exchange value.

II. Internal-use Software (ASC 350-40)



Preliminary project stage

The preliminary project stage involves the initial activities of a company's decision to develop internal-use software up until commencement of the software development. ASC 350-40-25 describes examples of an entity's activities that may occur during this stage. Such activities may include making strategic decisions to allocate resources, determining performance requirements and the technology needed, exploring alternatives and selecting any third parties that may be used throughout the development.

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Internal development teams may have defined development stages. Management should map these defined development stages to the stages under Subtopics 350-40 or 985-20.

Although the time invested during these activities is crucial in determining whether the software will be developed and for what purpose, as it does not relate to the actual development, all internal and external costs in this stage are expensed.

Application development

Per ASC 350-40-25-12, the capitalization of eligible costs commences when the following occurs; i) preliminary project stage is completed, ii) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and iii) it is probable that the project will be completed and the software will be used to perform the function intended.

Development activities include the design and configuration of the chosen path, coding, installation and testing. During this stage, entities may capitalize applicable internal and external software development costs.

Capitalizable costs

Capitalizable costs should include both internal and external costs incurred to develop internal-use software and costs to develop or obtain software that allows for access to or conversion of old data by new systems, per ASC 350-40-25-2 and ASC 350-40-25-3. These costs include, but are not limited to:

- External direct costs of materials and services consumed in developing or obtaining internal-use computer software.
- Payroll and related costs for employees who are directly associated with development, to the extent of the time spent directly on the project.
- Interest costs incurred while developing internal-use computer software.

Costs incurred during the application development stage that do not fall under these buckets must continue to be expensed.

Postimplementation-operation

Following the implementation of the internal-use software, costs are likely to be incurred for training as well as software maintenance. These costs are to be expensed as incurred.

Following its release, upgrades and enhancements can be expected to be made to the internal-use software. The costs related to these upgrades and enhancements are treated based on how probable it is that the expenditure will result in additional functionality. ASC-350-40-25-7 defines additional functionality as modifications to enable the software to perform tasks that it was previously incapable of performing. When it is probable that additional functionality will be achieved, the associated costs are to be capitalized in accordance with the guidance within the first three stages.

Amortization and impairment

Under ASC 350-40, amortization begins when the computer software is ready for its intended use and testing is completed, regardless of whether the software will be placed in service in stages or in its entirety. The capitalized cost is then amortized on a straight-line basis, unless another basis is more representative of the software's expected use.

Impairment is reviewed when there are significant changes in events or circumstances related to the software being developed or used. Such events or circumstances include significant changes to the expected use of the program itself, development costs significantly exceeding the planned budget, or the software is not expected to provide a substantial service.

Impairment is measured and recognized by grouping the asset at the lowest level for which there are identifiable cash flows that are independent of the cash flows of other asset groups.

Prior to implementation, if it is no longer probable that a software project will be completed and placed in service, ASC 350-40-35-3 states the asset shall be reduced to the lower of the carrying amount or fair value, if any, less costs to sell.

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Per ASC 350-40-35-3, historical valuation of uncompleted software has resulted in a fair value of zero. In this case, impairment would be recognized for the full carrying amount.

Internal-use software subsequently sold, leased or marketed

In some circumstances, an entity that initially had no plan to market the software externally may later decide to sell or license the software to third parties. ASC 350-40-35-7 through ASC 350-40- 35-10 provide specific requirements when such an event occurs. This guidance requires an entity to apply the proceeds received following its sale to third parties against the existing carrying amount of the software. No profit will be recognized until the total proceeds reduce the carrying amount to zero. Following the reduction of the asset to zero, any additional revenue from a customer will be recognized in accordance with Topic 606 or as a gain in accordance with Subtopic 610-20 if the contract is not with a customer.

If the software is still being developed when the internal-use software is decided to be marketed externally, the entity will follow the guidance in Subtopic 985-20 and review amounts previously capitalized under Subtopic 350-40.

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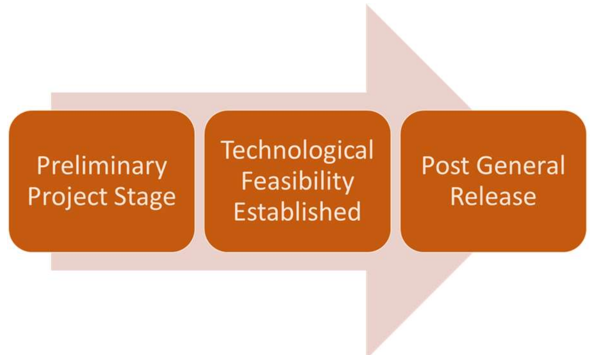
It is critical that accounting and development teams are coordinating, at least on a quarterly basis, to discuss development stages and specific cost codes for each project.

III. Software to be Sold, Leased or Marketed (ASC 985-20)



Establishing technological feasibility

Asset capitalization of development costs incurred for software to be sold, leased or marketed begins upon the establishment of technological feasibility. Under ASC 985-20, technological feasibility is established when the entity has completed all activities necessary to establish that a software product can be produced to meet its designed specifications in the preliminary project stage. ASC 985-20-25-2 states that this is through the completion of a detailed program design or a working model. Activities to complete a detailed program design or working model include planning, designing, coding and testing the design or model.

Whether an entity completes a working model or detailed program design is determined by the software development process for each product, with the majority of software development processes creating a working model.

Prior to establishing technological feasibility, costs incurred are recorded as research and development expenses.

Capitalizable costs

Costs incurred subsequent to the establishment of technological feasibility that are integral to the product may be capitalized as software development costs. These costs include both direct and indirect costs including, but not limited to:

Developers' salaries and benefits who are directly associated with development, to the extent of the time spent directly on the project.

External direct costs incurred by consultants, outside contractors and other third parties used in development.

Allocation of dedicated hardware and other systems utilized.

Any general and administrative costs incurred past the establishment of technological feasibility are expensed as incurred as they do not contribute to the development of the software.

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Entities should track and assess payroll, software and hardware costs directly associated with the development of the software to properly capture capitalizable costs.

Acquisition of software to be externally marketed

In certain instances, an entity may purchase software to be externally marketed. If technological feasibility has been established at the time of acquiring the software product, then those costs to acquire are capitalized. When technological feasibility has not been established at this point, the costs to acquire are expensed as research and development costs, until technological feasibility is established. If the purchased software has an alternative future use, costs should be accounted for in line with the alternative use of the software product described in Subtopic 985-20.

The acquisition may occur when an entity enters into a contract with a third-party developer to develop a software product. The developer will provide a completed, custom product to the entity that will then be marketed externally by the purchasing entity. As technological feasibility has been established pre-purchase, the costs to purchase the completed software will be capitalized.

General release and subsequent costs

Capitalization of software development costs ceases upon the general release of the software, in which third parties have the ability to purchase or acquire the software product.

Any improvements or enhancements made to the software are assessed in order to determine if they add additional features or functionality to the software. If this is achieved, the costs associated with the upgrade or enhancement are capitalized in a similar manner as after technological feasibility has been established and prior to general release. Subsequent capitalization is considered, and the useful life of the product is reassessed at this point.

Amortization and impairment

Amortization of the capitalized software product begins upon general release of the product. Entities should establish the best estimated useful life of a product based on the pattern in which the economic benefits of the asset are consumed or otherwise exhausted.

Under ASC 985-20, costs are amortized with the annual amortization being the greater of the straight-line method or the ratio of current gross revenues compared to the anticipated future gross revenues of the product.

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Entities may change between the straight-line method and the ratio-of-revenues method of amortization based on which of the two methods is greater during the reporting period.

When additional improvements or enhancements are capitalized, amortization resumes using the total remaining cost inclusive of the newly capitalized amount and useful life. If the ratio-of revenues method was being utilized, updates to the anticipated future gross revenues shall be considered as well.

The facts and circumstances of each capitalized asset should be reviewed at each reporting date in order to determine if potential impairment exists. The most pertinent facts and circumstances include probability of general release and the outlook of the success and life of the software product subsequent to general release based on the revenue generated for the software thus far. If the software product is not reaching final development or the revenue generated via sales post-general release is less than the expected amount, impairment may be booked against the capitalized asset.

IV. Cloud Computing Implementation

Overview

As cloud-based information systems gain popularity, entities may choose to move certain software, that were traditionally stored locally, to the cloud. Entities are then able to access their data, applications and platforms from servers hosted through hosting arrangements, or cloud computing arrangements (CCA).

When choosing to store more data and operate on the cloud, an entity should determine whether the costs are based on the full implementation of the software or if the CCA is solely a service provided by the vendor. CCAs that are determined to be service contracts are accounted for as operating expenses, while CCAs that require implementation allow for capitalization of the implementation costs in line with Subtopic 350-40.

Implementation

Though software through CCAs is not acquired and stored locally, the implementation costs are accounted for following the guidance in ASC 350-40 as internal-use software.

Whether to capitalize or expense costs follows the identical project timeline and expense guidance as described within Internal-use Software. Service costs of the CCA, regardless of project stage, are not directly related to the implementation of the CCA and should be accounted for as an operating expense as incurred or as services are rendered.

Upon completion of the CCA implementation, amortization and impairment follow the guidance in Subtopic 350-40 as described in Section II.

Transitioning to the cloud

In some instances, an entity may currently have locally stored software that they want to transition to the cloud in order to reduce costs and resources.

There may be costs currently capitalized from previously developed or acquired software that are 'on-premises'. If any of these 'on-premises' software are being retired, any current capitalized costs should be assessed in order to be accounted for as an asset to be abandoned in line with ASC 350, as this is a triggering event that may require impairment or adjustment of the useful life of the asset group.

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Though the software stored locally may be written off, any implementation costs of the new CCA may be capitalized in line with Subtopic 350-40.

V. Presentation and Disclosure

Balance sheet presentation

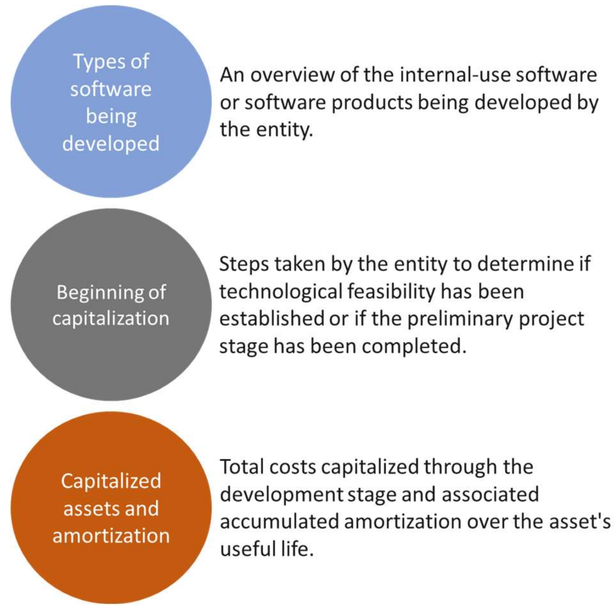
Capitalized software development costs do not require significant disclosures. However, regulation S-X Rule 5-02, Balance Sheets (17 CFR 210.5-02) requires intangible assets to be stated separately for each class of such assets which is in excess of five percent of the total assets, along with the basis of determining the respective amounts. If the capitalized software development costs are greater than five percent of total assets, those costs, less any amortization or impairment should be separately disclosed within each balance sheet presented.

Income statement presentation

Amortization and impairment expense should be disclosed in the income statement for each period presented. Subtopic 730-10 requires that the total research and development costs charged to expense are disclosed in the financial statements for each period an income statement is presented, inclusive of software development costs for a software product to be sold, leased or marketed.

Additional disclosures

When significant capitalized software development costs are presented separately on the balance sheet, additional details for either internal-use software or software to be sold, leased or marketed may include:



If impairment has been recognized in the current year, details regarding the facts and circumstances of the impairment should be disclosed along with the impairment amount.

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TBH Consulting provides accounting and financial reporting services. We deliver Big 4 level of experience to our clients at competitive rates. We can mobilize the right resources at the right time to meet our clients’ needs, whether such clients are Fortune 500, middle-market public companies or pre-IPO companies.

CONTACT US

For more information, please contact us at:

info@tbhconsulting.com