Accounting for Internal-Use Software Development Costs

By Christopher F. Terrigino

Understanding the accounting treatment for internal-use software development costs can be confusing. To help alleviate this confusion, we have summarized the requirements and accounting treatment presented in Accounting Standards Codification (ASC) 350-40: *Internal-Use Software*.

First, we need to identify what is considered to be internal-use software.

Computer software is considered to be for internal use when it is developed or purchased for the internal usage and needs of the organization only. Examples of an organization acquiring or developing internal-use software are:

- An organization develops or purchases software to process accounting functions, such as payroll or fixed asset management.
- The development or customization of software to run production or servicing equipment.
- Creation of a program that will accumulate and/or store information from internal or external sources.
- Programs used by an organization's customers to interact directly with the organization.
- The development or customization of software used by an organization to provide goods or services to its customers.

Costs incurred for computer software developed or obtained for internal use are either capitalized or expensed depending on the nature of the costs and the project stage during which they were incurred. Each stage and the accounting treatment follow:

1. Preliminary Product Stage – This is the earliest stage of a software development or selection project, during which the alternatives are being evaluated but no decision has been made as to which strategy or vendor to use. Typical activities during this phase include assembling the evaluation team, evaluating proposals from vendors, and the final selection of alternatives. All costs incurred during the preliminary product stage are expensed.

2. Application Development Stage – During this stage, the coding, installation, and testing of the software is completed. The costs incurred during this stage are treated as follows:

    a. Internal and external costs incurred to develop internal-use computer software shall be capitalized. This includes payroll and travel costs of employees directly involved with the software development. Additionally, interest costs related to financing the software development are included in this category.

    b. Costs to develop or obtain software that allows for access to or conversion of old data by new systems shall also be capitalized. The costs incurred during the actual data conversion to the new system shall be expensed as incurred.

    c. Administration, overhead, and training costs are not internal-use software development costs and, if incurred during this stage, would be expensed.

3. Postimplementation – Operation Stage – During this stage, the software is installed and being used for its intended purpose. Costs incurred during this stage are expensed.

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4. Upgrade and Enhancement Stage – During this stage, upgrades or enhancements that add functionality or features to an existing software are created. Costs incurred during this stage should be analyzed and accounted for the same as during the application development stage. Costs related to maintenance of the existing software would be expensed.

The costs of software development or acquisition that have been capitalized will be amortized on a straight-line basis over the software's estimated useful life, unless a systematic basis is more representative of the software's use. Consideration of obsolescence, future changes in technology, competition, and other economic factors must be used in determining the estimated useful life of the capitalized costs. These factors will generally result in capitalized software development costs having a relatively short estimated useful life.

Amortization will begin when the computer software is ready for its intended use and all substantial testing of the software has been completed.

Impairment of the capitalized costs should be recognized if the software is abandoned prior to implementation, substitute software is implemented, or the business segment the software is assigned is unprofitable or will be discontinued.

Rivero, Gordimer & Company, P.A. has expertise you can count on regarding help determining how to treat your software development costs. We understand the specific accounting rules that apply to your situation. If you have any questions regarding accounting for software development costs, or any other technology-related topic, contact Christopher F. Terrigino at cterrigino@rgcocpa.com or any other member of our Technology Committee at 813-875-7774.

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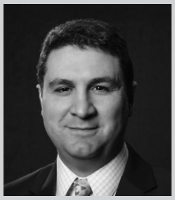

Christopher F. Terrigino, CPA, Shareholder, and Audit Team, has worked in public accounting since 1997 and has provided accounting, assurance, consulting, and litigation support services to clients in the technology, not-for-profit, construction, retail, and healthcare industries. Mr. Terrigino has also worked with many clients experiencing transitions such as significant growth and management turnover.

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