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In This Issue

FASB Makes Tentative Decisions Related to the Accounting for and Disclosure of Software Costs

Background

In response to feedback received on its June 2021 Invitation to Comment *Agenda Consultation*, the FASB added software costs to its research agenda as part of its research project on the accounting for and disclosure of intangibles. Respondents to the agenda consultation, primarily preparers and practitioners, indicated that the different accounting models for developing software (e.g., accounting for internal-use software intended to be sold as a service versus developed software intended to be sold or marketed externally) (1) may no longer be relevant and (2) have created diversity in the accounting for software offerings that have the same development and commercialization risks. In addition, the guidance on accounting for internal-use software, which focuses on the linear phases of software development, can be challenging to apply to agile methods of developing software.

In June 2022, the Board added a project on the accounting for and disclosure of software costs to its technical agenda to "(1) modernize the accounting for software costs and (2) enhance the transparency [of disclosures] about an entity's software costs." Beginning in January 2023, the FASB deliberated the project, including several potential alternatives, to address the issues raised in the agenda consultation as well as feedback from the FASB staff's outreach to stakeholders.

At its June 18, 2024, meeting, the FASB continued deliberating this project and ultimately directed the staff to draft a proposed Accounting Standards Update (ASU) for a vote by written ballot. The Board decided to propose targeted improvements rather than a wholesale revision to the existing guidance in ASC 350-40[1] to address stakeholders' requests. As a result of this targeted improvement approach, the Board is not revising the cost guidance for software licenses that are in the scope of ASC 985-20. The tentative decisions reached at the FASB's meeting are discussed below.

Recognition

The Board supported a single accounting model for all software within the scope of ASC 350-40 regardless of whether it is developed by using linear or nonlinear methods. To do so, it decided to remove all references to development stages from ASC 350-40. In addition, the Board supported amending the threshold applied to start the capitalization of costs under ASC 350-40. Under current GAAP, capitalization of software development costs for internal-use software is required once the preliminary project stage is complete. As indicated in ASC 350-40-25-12, one of the requirements for an entity to move out of the planning phase is that management must be able to determine that "it is probable that the project will be completed and the software will be used to perform the function intended." The Board approved adding a requirement for an entity to assess whether there are significant uncertainties associated with its development activities in cases in which it is unclear that it is probable that the project will be completed and the software will be used to perform the intended function. In determining whether there are significant uncertainties associated with development activities, an entity would be required to consider the following factors:

- Whether the software being developed has "novel, unique, unproven functions and features or technological innovations."
- Whether the "significant performance requirements have not been selected or [could] be revised."

Further, the Board decided to clarify that entities should (1) "determine the unit of account for an asset that incorporates both software and tangible components" and (2) consider "whether the software component should be (a) accounted for separately under [ASC 350-40] or (b) combined with the tangible component in accordance with other GAAP, such as [ASC 360-10]." Entities would need to apply judgment under the proposed guidance in determining whether software embedded in a tangible asset should be a separate unit of account or included in a single unit of account with the tangible asset.

Connecting the Dots

ASC 985-20 includes within its scope software that is sold, leased, or otherwise marketed as part of a tangible product. We believe that because the FASB decided not to amend ASC 985-20, most of the development of software that is incorporated into a tangible asset would continue to be within the scope of ASC 985-20. However, if an entity is developing a tangible asset for internal use that also incorporates software, the proposed guidance would require the entity to evaluate whether the software component should be accounted for separately under ASC 350-40. In addition, entities purchasing tangible products that include software will need to use judgment when determining whether the software component should be accounted for separately.

During its June 18, 2024, meeting, the Board commented that it expects that the targeted improvements to ASC 350-40 are likely to result in a reduction of capitalized costs for internal-use software developed for revenue-generating activities (e.g., software developed to be sold as a service). This is because the proposed amendments would require entities to apply judgment in determining whether the software being developed has "novel, unique, unproven functions and features or technological innovations" or uncertainties related to significant performance requirements that make completion of the project improbable.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Because such judgment may lead to changes in the amount of cost capitalized, the Board plans to seek feedback on the proposed ASU regarding the expected impacts of the proposed amendments on the amounts that would be capitalized on the basis of the nature of the software developed for internal use, particularly when the software is sold as a service.

Connecting the Dots

ASC 985-20 requires any development costs that are incurred before technological feasibility is established to be expensed as incurred. Under ASC 985-20-25-2, one of the requirements for establishing technological feasibility is that a "detail program design has been reviewed for high-risk development issues (for example, novel, unique, unproven functions and features or technological innovations), and any uncertainties related to identified high-risk development issues have been resolved through coding and testing." Because any high-risk development issues need to be resolved through coding and testing, which is typically completed at or around the same time software development is complete, most costs incurred to develop software that will be sold, leased, or marketed externally are typically expensed as incurred. While the proposed guidance that would be added to the recognition threshold in ASC 350-40 would also require an entity to consider whether there are novel, unique, unproven functions and features or technological innovations when assessing whether it is probable that the software project will be complete, an entity would **not** need to resolve such unproven functions, features, or innovations through coding and testing to conclude that it is probable that the software project will be complete. Consequently, differences in capitalization thresholds might still exist between software that is developed for internal use in accordance with ASC 350-40 and software that is to be sold or marketed externally (in accordance with ASC 985-20).

Presentation and Disclosure

Regarding presentation and disclosure, the FASB ultimately decided that the only additional proposed requirement would be that cash outflows for costs capitalized in accordance with ASC 350-40[2] would be presented separately as an investing activity on the statement of cash flows. The Board plans to seek feedback on the proposed ASU to gain an understanding of whether disclosure of a different amount, such as the amount capitalized in a given period, would be more helpful to the users of financial statements.

Transition

The Board decided that the proposed amendments should be applied prospectively upon adoption while also proposing an option to apply the amendments retrospectively.

Other Matters

ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*

The Board contemplated amendments to the disclosure requirements in ASC 985-20 but decided not to make any amendments to this Subtopic.

ASC 350-50, *Intangibles — Goodwill and Other — Website Development Costs*

The Board decided to supersede the guidance in ASC 350-50 since it understands that this guidance is not commonly used. Under the proposed ASU, ASC 350-40, as amended, would be applicable to Web site development costs. The FASB directed the staff to include an

[2] This requirement excludes implementation costs for a hosting arrangement that is a service contract. According to ASC 350-40-45-3, these costs should continue to be presented in the same manner as the cash flows for the fees for the associated hosting arrangement (generally presented as an operating activity).

example in ASC 350-40 to this effect. That is, the Board does not believe that specialized or unique guidance is necessary to address Web site development; rather, entities would use the framework outlined in ASC 350-40 for those transactions. The Board plans to seek feedback on the proposed ASU from entities that currently apply this guidance to understand whether the proposed amendments would change current practice.

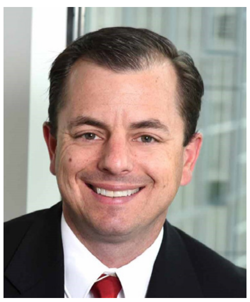
ASC 730-10, *Research and Development — Overall*

The Board decided that costs incurred to develop software that has novel, unique, unproven functions and features or technological innovations are not required to be within the scope of ASC 730-10. Companies should continue to apply judgment to determine whether such costs represent research and development costs in accordance with ASC 730-10.

Next Steps

Upon evaluation of the cost-benefit analysis of this project, the FASB directed the staff to draft a proposed ASU for a vote by written ballot. The Board also decided on a 90-day comment period for the proposed ASU.

Contacts



Chris Chiriatti
Audit & Assurance
Managing Director
Deloitte & Touche LLP
+1 203 761 3039
cchiriatti@deloitte.com

Kristin Bauer
Audit & Assurance
Partner
Deloitte & Touche LLP
+1 312 486 3877
kbauer@deloitte.com

Disha Buch
Audit & Assurance
Senior Manager
Deloitte & Touche LLP
+1 312 486 3221
dbuch@deloitte.com

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