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FASB Proposes Guidance on the Accounting for and Disclosure of Software Costs

Background

On October 29, 2024, the FASB issued a proposed ASU[1] that would amend certain aspects of the accounting for and disclosure of software costs under ASC 350-40.[2] Rather than revising the guidance on this topic in its entirety, the Board is proposing targeted improvements to address specific issues raised by stakeholders. In addition, the proposed ASU does not amend the cost guidance for software licenses that are within the scope of ASC 985-20.

We encourage preparers and practitioners to comment on the proposed ASU by the January 27, 2025, deadline. The proposed updates are discussed below.

Recognition

To clarify that the guidance applies to both linear and nonlinear software development, the proposed ASU would remove all references to "development stages" from ASC 350-40 as well as amend the threshold for the capitalization of costs. Under current GAAP, capitalization of software development costs for internal-use software is required once the preliminary project stage is complete. The proposed ASU instead provides the following two criteria in ASC 350-40-25-12 that must be met for entities to begin capitalizing software costs:

- "Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project."

[1] FASB Proposed Accounting Standards Update *Targeted Improvements to the Accounting for Internal-Use Software*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

- "It is probable that the project will be completed and the software will be used to perform the function intended (referred to as the 'probable-to-complete recognition threshold')."

Under the proposed ASU, the probable-to-complete threshold would not be met when there is "significant uncertainty associated with the development activities of the software (referred to as 'significant development uncertainty')." The proposed guidance provides the following factors that may be indicative of significant development uncertainty:

- "The software being developed has novel, unique, unproven functions and features or technological innovations."
- "The significant performance requirements of the computer software have not been identified or the significant performance requirements continue to be substantially revised."

The Board indicated in the proposal that for certain internal-use software projects such as enterprise resource planning (ERP) implementations, evaluation of the two indicators above may not be necessary.

During its June 18, 2024, meeting, the Board commented that it expected the targeted improvements to ASC 350-40 to result in reduced capitalized costs for internal-use software that is 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 (which may be more common for software developed for revenue-generating activities than for software developed only for an entity's internal use [e.g., an ERP system]). Because such judgment may lead to changes in the amount of costs capitalized, the Board is seeking feedback on 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 finished at or around the same time software development is complete, most costs for developing software that will be sold, leased, or marketed externally would be expensed as incurred. While an entity would also be required under the proposed recognition threshold guidance 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, the 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, under the guidance in the proposed ASU, 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).

The examples below illustrate the application of ASC 350-40 as amended by the proposed ASU.

Example 1

Entity X is a manufacturing company that has decentralized operations in several geographies and brands, each of which operate in distinct software environments that are aggregated during the consolidation process. The company has identified a need for a uniform reporting software layer to reduce the complexity of its consolidation process. Accordingly, X engages a reputable third-party software provider to implement an off-the-shelf software solution.

The terms of the on-premise software license stipulate that the software will be provided for a five-year, noncancellable term, with fixed annual payments due when the software goes live and on each anniversary date thereafter during the term. The annual payments cover both the cost of the software license and postcontract customer support (PCS) during the license term.

The process for determining when to capitalize internal-use software license costs is the same regardless of whether the software is purchased or developed internally. Accordingly, X considers the criteria for capitalization of the software cost requirements in proposed ASC 350-40-25-12 and concludes that as of the date X enters into the software contract:

- Management, with the relevant authority, implicitly or explicitly authorized and committed to funding a computer software project.
- It is probable that the project will be completed, and the software will be used to perform the function intended since the software is an off-the-shelf solution by a reputable third party.

Thus, X concludes that there is no significant uncertainty associated with the development activities of the software. As a result, at contract inception, X capitalizes costs associated with acquiring the software intangible asset. To do so, X allocates the fees paid that are attributable to the PCS services, which represent an executory contract and, in accordance with ASC 350-40-25-17, recognizes an intangible asset for the costs attributable to the five-year term license and a liability for the four unpaid years. The liability established is then discounted to reflect the fair value of the consideration transferred. Under ASC 350-40-30-1, X also capitalizes any eligible internal and additional external direct costs that are for capitalization.

Example 2

Entity A offers hosted ERP solutions to its customers as software as a service (SaaS). On January 15, 20X0, A's CEO approved and committed funding to a project to evaluate how A can incorporate generative artificial intelligence (AI) into its SaaS offerings to provide a technical accounting memo writing tool to its customers.

On January 15, 20X0, the technology necessary for providing the intended functionality does not exist, and A would need to use a combination of third-party tools and an in-house model to develop it. Entity A has not selected the third-party tools and does not currently have the appropriate talent resources to perform the necessary in-house activities to develop the intended functionality. In addition, not all the significant performance requirements been identified.

On February 28, 20X0, A hired generative AI specialists to work on the project and entered into a service contract to access a large language model (LLM) from a reputable third party. Through June 30, 20X0, A evaluates how the AI specialists it hired can leverage and build on its existing LLM. As of June 30, 20X0, A has identified a specific list of accounting memos that the software must be able to write; however, certain novel or unproven functions still need to be developed for the software to perform its intended tasks.

As of September 30, 20X0, the AI specialists have made significant progress toward developing the model. While additional software development must be undertaken to complete the project, the novel aspects of the project are finished, and there are no longer any features whose feasibility is unproven.

On December 15, 20X0, A completes the coding and testing necessary to demonstrate that the memo writing tool can perform the intended function in accordance with the design specifications for the first accounting topic selected by A.

Example 2 (continued)

For each of the key dates above, A assesses whether the internal and external costs to develop the application meet the capitalization requirements proposed in ASC 350-40-25-12 as follows:

- On January 15, 20X0, although the CEO approved the funding for the project, the capitalization criteria proposed in ASC 350-40-25-12 are not met because of significant development uncertainties.
- As of February 28, 20X0, although A has hired the AI specialists and entered into a service contract to access a third-party LLM in developing its tool, significant development uncertainties remain. Accordingly, as of February 28, 20X0, A has determined that the software still does not meet the proposed requirements in ASC 350-40-25-12(c).
- As of June 30, 20X0, A has identified a specific list of accounting memos that the software must be able to write and, as a result, the significant performance requirements that are known and not expected to change. However, the ultimate technology that A intends to develop remains novel, unique, and unproven. Accordingly, as of June 30, 20X0, the company has determined that the software still does not meet the proposed requirements in ASC 350-40-25-12(c).
- As of September 30, 20X0, the AI specialists have made significant progress toward developing the model, and the novel portions of the software development are complete. On the basis of such progress, the development uncertainty associated with the novel, unique, and unproven aspects of the software development has been resolved. While further software development and testing is necessary before the software is a viable product, as of September 30, 20X0, A has determined that the software meets the proposed requirements in ASC 350-40-25-12(c).

Eligible software development costs incurred after September 30, 20X0, would be capitalized, including those related to the model developed in-house and implementing the LLM model. Entity A would capitalize the costs incurred for coding and testing that were necessary to establish that the memo writing tool can perform its intended function in accordance with the design specifications for the first accounting topic selected by A through December 15, 20X0. In addition, the proposed presentation requirements in ASC 350-40-45-1A and ASC 350-40-45-2 through 45-3 apply to costs incurred for implementation of the LLM on or after September 30, 20X0.

The proposed ASU also clarifies the scope of the guidance by stating that "[i]f an entity acquires an asset that incorporates both software and tangible components, the entity shall apply a reasonable and consistent method to determine whether the software component should be accounted for [separately under ASC 350-40] or combined with the tangible component" in accordance with other GAAP, such as ASC 360-10. In the proposed ASU's Basis for Conclusions, the FASB notes that entities would need to apply judgment to determine 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, an entity would be required under the proposed guidance to evaluate whether the software component should be accounted for separately in accordance with 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. We encourage preparers and practitioners to provide the FASB with feedback on this scope clarification.

Presentation and Disclosure

Under the proposed ASU, entities would be required to separately present cash outflows for costs capitalized in accordance with ASC 350-40[3] as an investing activity in the statement of cash flows. After the adoption of ASU 2018-15, implementation costs of a hosting arrangement are generally classified as cash outflows from operating activities under ASC 350-40-45-2, which states that "[a]n entity shall present the capitalized implementation costs described in paragraph 350-40-25-18 in the same line item in the statement of financial position that a prepayment of the fees for the associated hosting arrangement would be presented." The Board seeks feedback on whether (1) those implementation costs should also be presented within investing activities in the statement of cash flows and (2) disclosure of a different amount, such as the amount capitalized in a given period, would be helpful to financial statement users.

Transition

Entities would be permitted to apply the guidance prospectively or retrospectively.

Other Matters

Costs of Software to Be Sold, Leased, or Marketed

The proposed guidance would not amend the requirements in ASC 985-20.

Web Site Development Costs

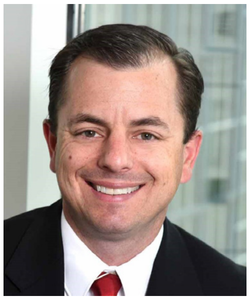
The guidance in ASC 350-50, which the FASB believes is not commonly used, would be superseded by the proposed ASU's amendments. Instead, ASC 350-40, as amended, would apply to Web site development costs. Example 4 in proposed ASC 350-40-55-16 through 55-19 illustrates the application of ASC 350-40 to such development costs. The Board seeks feedback from entities that currently apply this guidance to understand whether the proposed amendments would change current practice.

Research and Development Costs

As the Board discusses in paragraph BC65 of the proposed ASU, costs incurred to develop software "before the probable-to-complete recognition threshold is met" would not 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.

[3] 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).

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

Michael Riso
Audit & Assurance
Manager
Deloitte & Touche LLP
+1 813 428 2801
miriso@deloitte.com

Appendix — Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for reference.

Overall

Question 1: The amendments in this proposed Update would make targeted improvements to Subtopic 350-40.

a. Do you agree with the proposed amendments? Please explain your reasoning.

b. Are the proposed amendments clear and operable? Please explain your reasoning.

c. Would the proposed amendments clarify and improve the application of Subtopic 350-40? Please explain your reasoning.

d. Do you anticipate that the proposed amendments would result in a significant change in outcome? For example, would the proposed amendments result in the same level of capitalization of internal-use software or a decrease or an increase in the level of capitalization? Is that outcome appropriate? Please explain your reasoning.

e. What costs would be incurred to apply the proposed amendments? If significant, please describe the nature and magnitude of costs, differentiating between one-time costs and recurring costs, as well as whether you expect the proposed amendments to result in any reduction of costs.

f. Alternatively, would you have preferred that the Board further pursue the single model as described in paragraphs BC45–BC49? Please explain your reasoning.

Removal of Project Stages

Question 2: The proposed amendments would remove all references to software development project stages throughout Subtopic 350-40. As a result, the proposed amendments would require all entities to determine when to begin capitalizing software costs by evaluating whether (a) management has authorized and committed to funding the software project and (b) the probable-to-complete recognition threshold has been met. Do you foresee any operability or auditability concerns with removing the references to project stages? Please explain your reasoning.

Significant Development Uncertainty

Question 3: If there is significant uncertainty associated with the development activities of the software (referred to as "significant development uncertainty"), the probable-to-complete recognition threshold described in paragraph 350-40-25-12(c) would not be considered to be met. There may be significant development uncertainty if the software being developed has novel, unique, unproven functions and features or technological innovations or if the significant performance requirements have not been identified or continue to be substantially revised.

a. Do you foresee any operability or auditability concerns with determining whether there is significant uncertainty associated with the development activities of the software? Please explain your reasoning.

b. The proposed amendments would define performance requirements as what an entity needs the software to do (for example, functions or features). Is the definition of performance requirements clear and operable? Please explain your reasoning.

Presentation and Disclosure

Question 4: The proposed amendments would require an entity to classify cash paid for capitalized software costs accounted for under Subtopic 350-40 as investing cash outflows in the statement of cash flows and to present those cash outflows separately from other investing cash outflows, such as those related to property, plant, and equipment (PP&E). Similar to cash paid for internally developed PP&E, cash paid for software costs could include certain expenditures related to employee compensation.

a. For preparers and practitioners, are the proposed presentation requirements operable in terms of systems, internal controls, or other similar considerations? What auditing challenges, if any, do you foresee related to the proposed presentation requirements? Please explain your reasoning.

b. For investors, would the proposed presentation requirements provide decision-useful information? How would this information be used in your investment and capital allocation decisions? Please explain your reasoning.

c. The proposed presentation requirements would not include cash outflows incurred to implement a hosting arrangement that is a service contract. Those cash outflows are typically classified as operating cash flows due to the separate presentation requirements in paragraph 350-40-45-3, which originated in Accounting Standards Update No. 2018-15, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* (see paragraph BC64). Is it necessary to change the current classification of those costs to be consistent with the proposed presentation requirements? Please explain your reasoning.

Question 5: The Board considered but dismissed two potential disclosures that would have required entities to disaggregate internal-use and external-use capitalized software costs. One alternative would have required an entity to disclose the total amount of internal-use and external-use software costs capitalized during the period. The second alternative would have required an entity to provide a rollforward of the beginning to ending balance of net capitalized software costs (including additions, amortization, impairments, and disposals). These alternatives differ from the proposed cash flow presentation requirements because, among other reasons, they would include both internal-use and external-use capitalized software costs and noncash costs capitalized.

a. For preparers and practitioners, how would the operability and costs of these disclosure alternatives compare with the proposed cash flow presentation requirements (described in Question 4)?

b. For investors, how would the decision usefulness of these disclosure alternatives compare with the proposed cash flow presentation requirements? How and when would the information provided by each of the disclosure alternatives influence investment and capital allocation decisions?

For investors, is the information that you currently receive about capitalized internal-use and external-use software costs sufficient? If not, how would receiving additional information about capitalized internal-use and external-use software costs affect your analysis? How does your analysis differ between capitalized internal-use software costs and capitalized PP&E?

Website Development Costs

Question 6: The proposed amendments would supersede the guidance in Subtopic 350-50 and incorporate website-specific development costs guidance from that Subtopic into Subtopic 350-40.

a. Would the proposed amendments be operable, and do you foresee any auditability challenges?

b. Would the proposed amendments have a significant effect on practice? Please explain your reasoning.

c. The Board considered but dismissed an approach that would have retained Subtopic 350-50 and replaced any reference to stages in Subtopic 350-50 with the term *activities* (for example, replace *costs incurred in the planning stage* with *costs incurred during planning 8 activities*). Would you prefer this approach, and would it be more operable and auditable? Please explain your reasoning.

Transition and Effective Date

Question 7: The proposed amendments could be applied either prospectively or retrospectively.

a. For preparers and practitioners, are the proposed transition requirements operable, and do you foresee any auditability challenges? Please explain your reasoning. If the proposed transition requirements are not operable, please explain what transition method would be more appropriate and why.

b. For investors, would the information required to be disclosed by paragraph 350-40-65-4(d) through (e) be decision useful? Please explain your reasoning.

Question 8: In evaluating the effective date, how much time would be needed to implement the proposed amendments? Should the effective date for entities other than public business entities be different from the effective date for public business entities? Should early adoption be permitted? Please explain your reasoning.

Private Company Considerations

Question 9: The proposed amendments would apply to all entities, including private companies. Do you agree? Are there any private company considerations, in the context of applying the guidance in the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies*, that the Board should be aware of in developing a final Accounting Standards Update? Please explain your reasoning.

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