FASAB

Federal Accounting Standards Advisory Board

Implementation Guidance on Statement of Federal Financial Accounting Standards 10: Accounting for Internal Use Software

Federal Financial Accounting and Auditing

Technical Release 5

May 14, 2001

THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Federal Accounting Standards Advisory Board (the FASAB or "the Board") was established by the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General in October 1990. It is responsible for promulgating accounting standards for the United States Government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, Federal executives, Federal program managers, and other users of Federal financial information. The proposed standard is published in an Exposure Draft for public comment. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. The Board publishes adopted standards in a Statement of Federal Financial Accounting Standards.

Additional background information is available from the FASAB:

> "Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board," amended on October 1, 1999.
>
> "Mission Statement of the Federal Accounting Standards Advisory Board."

Federal Accounting Standards Advisory Board

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The Accounting and Auditing Policy Committee

The Accounting and Auditing Policy Committee (AAPC) was organized in May 1997 by the Department of the Treasury, the Office of Management and Budget (OMB), the General Accounting Office (GAO), the Chief Financial Officers' Council (CFOC), and the President's Council on Integrity and Efficiency (PCIE), as a body to research accounting and auditing issues requiring guidance.

The AAPC serves as a permanent committee sponsored by the Federal Accounting Standards Advisory Board (FASAB). The mission of the FASAB is to set accounting standards after considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of Federal financial information. The mission of the AAPC is to assist the Federal government in improving financial reporting through the timely identification, discussion, and recommendation of solutions to accounting and auditing issues as they relate to the specific application of existing authoritative literature.

The AAPC is intended to address issues that arise in implementation, which are not specifically or fully discussed in Federal accounting and auditing standards. The AAPC's guidance is cleared by FASAB before being published.

INTRODUCTION

The AAPC was asked to provide guidance to Federal entities on the implementation of Statement of Federal Financial Accounting Standards 10, *Accounting for Internal Use Software* (SFFAS 10). This Technical Release (TR) is intended to provide guidance on implementing SFFAS 10. This TR was prepared in conjunction with the Chief Financial Officers Council Task Force on the implementation of SFFAS 10; the AAPC agreed to publish in this TR certain issues raised by the task force.

Readers of this technical release should first refer to the American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board hierarchy of accounting standards applicable to Federal entities[1]. Standards issued by FASAB have precedence over other authoritative guidance for Federal entities. This technical release supplements any relevant Federal standards, but is not a substitute for and does not take precedence over the standards. This technical release is considered a Level C. pronouncement in the hierarchy.

Background

This guidance is based on the provisions of the following Federal standards.

- SFFAS 10, *Accounting for Internal Use Software*
- SFFAS 5, *Accounting for Liabilities of the Federal Government*
- SFFAS 6, *Accounting for Property, Plant, and Equipment*

[1] AICPA Statement on Auditing Standards 91, *Federal GAAP Hierarchy*.

QUESTIONS AND RESPONSES

Question 1

Trigger Point for Capitalization and Amortization[2] - How can management determine the point in time when it is more likely than not that a proposed software project will be implemented, and thus the capitalization and amortization periods start?

Response

SFFAS 10 states that "for internally developed software, capitalized costs should include the full cost (direct and indirect costs) incurred during the software development stage. Such costs should be limited to cost incurred after (a) management authorizes and commits to a computer software project and believes that it is more likely than not that the project will be completed and the software will be used to perform the intended function with an estimated service life of 2 years or more, and (b) the completion of conceptual formulation, design, and testing of possible software project alternatives (the preliminary design stage). "[3] Each Federal agency should develop and document agency specific policies and procedures for this determination so that it is consistently implemented across new software developments.

In terms of amortization, SFFAS 10 states that "for each module or component of a software project, amortization should begin when that module or component has been successfully tested. If the use of the module is dependent on completion of another module(s), the amortization of that module should begin when both that module and the other module(s) have successfully completed testing. "[4] Generally, this point in time is before the Federal agency starts to realize the benefits of the new computer software system.

[2] SFFAS 10, paragraph 16a.
[3] Ibid., Paragraph 16.
[4] Ibid., Paragraph 33.

Question 2

Capability vs. Functionality - Certain costs extend the ability of a computer software system to perform tasks or make the application easier to use. Neither of these terms is defined in the Glossary, which may lead to a wide variety of interpretations. Are these terms synonymous within the context of SFFAS 10?

Response

The meaning of the term “capability” used in SFFAS 10 is very similar to the meaning of “functionality.” “Capability” is used in SFFAS 10 in the sense meaning an ability to perform an indicated use. “Functionality” is used in the sense meaning an ability to perform a specific function (an action for which a person or piece of equipment is specially fitted or used). SFFAS 10 states that an “enhancement” occurs when, for example, a new “capability or function [is added] to existing software.”[5] In applying the provisions of SFFAS 10, "capability" is synonymous with "functionality."

[5] SFFAS 10, paragraph 25.

Question 3

Useful Life of Software Based on Hardware - To what extent should the useful life of software be based on the hardware on which it runs?

Response

In situations where software and the hardware on which it runs have independent service lives, the determination of the useful life of the software should be viewed independently of the useful life of the hardware. This determination should be made on a case by case basis for each Federal agency and is at the discretion of management of the agency. The rationale for this determination should be documented.

For integrated software, SFFAS 10, Paragraph 22, states the following.

> "Computer software that is integrated into and necessary to operate general PP&E, rather than perform an application, should be considered part of the PP&E of which it is an integral part and capitalized and depreciated accordingly (e.g., airport radar and computer-operated lathes). The aggregate cost of the hardware and software should be used to determine whether to capitalize or expense the costs."

Question 4

Capitalizing License Fees - Full ownership of commercial software is rarely, if ever, transferred from the owner of the software to a Federal agency that desires to implement the functionality provided by that software. Rather, agencies acquire the right to use the software through the purchase of a license. When should software license fees be capitalized?

Response

Although SFFAS 10 did not address licensing within the body of the standard, the FASAB did state its belief in the Basis for Conclusions[6] that it would be appropriate for Federal entities to apply lease accounting concepts to licenses. The Committee therefore believes that when Federal agencies are making the determination as to whether software license fees should be capitalized, it would be appropriate for the agency to follow the lease accounting concepts as provided in SFFAS 5[7] and SFFAS 6[8], as well as appropriate policies for capitalization thresholds.

The Committee noted that the following Financial Accounting Standards Board (FASB) and AICPA standards provide guidance on accounting for software and licensing in general, and may be relevant to this topic.

- SFAS 50, *Financial Reporting in the Record and Music Industry*
- SFAS 63, *Financial Reporting by Broadcasters*

[6] SFFAS 10, paragraphs 66-67.
[7] SFFAS 5, paragraphs 43-46.
[8] SFFAS 6, paragraph 20.

- SFAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- SFAS 139, Rescission of SFAS 53, *Financial Reporting by Producers and Distributors of Motion Picture Films and Amendments to SFAS Nos. 63, 89, and 121*
- FASB Highlights, *Computer Software: Guidance on Applying Statement 86*
- AICPA SOP 97-2, *Software Revenue Recognition*
- AICPA SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- AICPA SOP 00-2, *Accounting by Producers or Distributors of Film*
- EITF 00-2, *Accounting for Web Site Development Costs*
- EITF 00-3, Application of AICPA Statement of Position 97-02 (*Software Revenue Recognition)* to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware.

Question 5

Capitalizable Costs vs. Executory Costs - How should a Federal agency capitalize a license agreement that may include executory costs (i.e., maintenance and technical support), as well as software upgrades? This may include upgrades that may either extend the useful life of the software or provide additional functionality.

Response

Agency judgment should apply in determining what portions of license fees are attributable to software capitalizable costs versus executory costs. Assuming lease capitalization criteria and thresholds are met, software license capitalization amounts[9] may be derived from the payment schedule contained in the license agreement. As stated in SFFAS 5, if the portion of the minimum lease payments representing executory cost is not determinable from the lease provisions, the amount should be estimated.[10] Agencies may also want to consider having each license agreement specifically identify the various costs throughout the license lifecycle, e.g., initial license, maintenance, enhancement, etc.

[9] SFFAS 5, paragraph 44.
[10] Ibid., paragraph 44.

Question 6

Bulk Purchases - Rather than buy individual packages of typical desktop software, many Federal agencies will acquire either a site or enterprise license, which allows unlimited use of a single package at a site or across the enterprise, or will buy, at a single time, a sufficient number of individual licenses to cover the use of a large percentage of the site or enterprise population (frequently referred to as a "seat license"). These acquisitions will in most cases exceed the capitalization threshold, but would not exceed the threshold if purchased separately. Should these types of purchases be capitalized?

Response

For these types of bulk purchases Federal entities should follow the guidance as stated in SFFAS 10, paragraph 24.

> "Each federal entity should establish its own threshold as well as guidance on applying the threshold to bulk purchases of software programs (e.g., spreadsheets, word-processing programs, etc.) and to modules or components of a total software system. That guidance should consider whether period cost would be distorted or asset values understated by expensing the purchase of numerous copies of a software application or numerous components of a software system and, if so, provide that the collective cost should be capitalized."

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