KPMG

FASB proposal

Accounting for and disclosure of software costs

October 30, 2024

FASB proposes modernizations and other changes to its internal-use software guidance.

Source and applicability

- Proposed ASU, Targeted Improvements to the Accounting for Internal-Use Software
- All entities that incur internal-use software costs, including website development costs

Fast facts, impacts, actions

The proposed ASU principally aims to modernize old guidance (written in 1998) for pervasive changes in how entities develop software. Entities predominantly develop software today on an agile (i.e. iterative and flexible) basis that does not fit well with the existing guidance that mostly presumes, consistent with software development of that time, a ‘waterfall’ (i.e. sequential and linear) method of software development. The key proposals would:

- **Change the cost capitalization threshold** by:
  - eliminating accounting consideration of software project development stages; cost capitalization would begin when (1) management has authorized and committed to funding the project and (2) it is ‘probable’ the project will be completed and the software used to perform its intended function (the ‘probable-to-complete’ threshold); and
  - enhancing the guidance around the ‘probable-to-complete’ threshold (given its proposed new prominence) and providing new examples in Subtopic 350-40 to illustrate its application.
- **Specify financial statement presentation** of cash outflows for capitalized internal-use software be presented as a separate item in the investing section of the cash flow statement.
- **Modify the website development costs guidance** by eliminating Subtopic 350-50 and moving any remaining relevant guidance into Subtopic 350-40 and adding an example.

The proposed ASU does not propose changes to: (1) the existing accounting requirements for external-use software (i.e. software to be sold or licensed) development costs, (2) *what* internal-use software costs can be capitalized (e.g. data conversion/migration, training and software maintenance costs would continue to be expensed as incurred), or (3) when internal-use software cost capitalization ceases (i.e. when the software is ‘substantially complete and ready for its intended use’).

Comments are due on the proposed ASU by January 27, 2025.

Background

In July 2021, the FASB issued its 2021 Invitation to Comment, *Agenda Consultation*. Stakeholder feedback, primarily from preparers and practitioners, indicated that the FASB should focus on modernizing the accounting for software costs. Stakeholders stated that the existing guidance was outdated (particularly, with respect to how software is now predominantly developed, but also with respect to having different cost accounting models for software that is licensed to customers versus software that is sold to customers only on a software-as-a-service [SaaS] basis). Additionally, investors indicated a need for greater transparency around entities' software costs.

In June 2022, the FASB added a software cost project to its technical agenda. Its objectives were to modernize the accounting for software costs and enhance transparency about entities' software costs. Between then and March 2024, the FASB considered several *larger* changes to entities' accounting for internal- *and* external-use software costs. Those changes included adopting a *single* software cost accounting model for those two types of software. However, no consensus developed around what those larger changes should be, including whether internal- and external-use software *should* in fact be governed by a single accounting model. Therefore, the FASB ultimately decided to solely focus on more limited amendments to Subtopic 350-40, and to leave Subtopic 985-20 on external-use software unchanged.

Similarly, while more significant new disclosure requirements were considered (e.g. a required annual rollforward of entities' capitalized software costs), the proposed ASU suggests only the one new requirement regarding cash outflows for capitalized internal-use software costs.

Changes to the cost capitalization threshold

Removal of project development stages

A principal objective of the proposed ASU is to modernize the dated Subtopic 350-40 guidance for pervasive changes in how entities develop software. When the guidance in Subtopic 350-40 was developed, software was primarily developed on a 'waterfall' basis. Waterfall software development is sequential/linear in orientation, with several stages (i.e. preliminary project, application development and postimplementation-operation). Development moves methodically from one stage to the next only when the one preceding it is completed.

By contrast, most software development today is 'agile'. Agile software development is flexible and iterative. That is, while there is an overall development objective, agile projects are generally much more lightly planned, and completed through a series of shorter time-frame development 'sprints'. It is understood and accepted that later sprints will frequently drive re-work or revision of tasks completed in previous sprints to arrive at the completed project. This intended ability to make changes (flexibility) and revisit and/or reperform earlier activities (iteration) often gives rise to the sense that discrete (or distinct) software development stages – i.e. that each begin only after the one preceding it ends – do not exist in agile projects. Agile and waterfall software development are discussed in further detail in section 3.2.60 of KPMG Handbook, Software and website costs.

To better align the guidance with the predominantly agile nature of current software development, the proposed ASU would eliminate all references to project stages throughout Subtopic 350-40. This would leave all entities, regardless of software development method used (i.e. agile, waterfall, a hybrid of those, or otherwise), to begin development cost capitalization solely by assessing the *remaining* criteria in Section 350-40-25. Those are whether (1) management has authorized and committed to funding the software project and (2) it is probable that the project will be completed and the software used to perform the function(s) intended. Before (1) and (2) are met, all software development costs would be expensed as incurred. [350-40-25-12(b)]

While practice has developed around applying Subtopic 350-40 to agile software development projects, it has not always been consistent. Additionally, the incongruence of the existing guidance with the predominant method of software development creates complexity. Question 3.2.170 in KPMG Handbook, Software and website costs, discusses these complexities and considerations around current practice.

Removing the existing staging guidance seems likely to substantially alleviate the challenges that exist in applying the current guidance arising from entities' use of an agile (or similar non-linear, non-sequential) software development method. However, as discussed below, some of the judgments eliminated may be replaced with new judgments around the 'probable-to-complete' threshold.

Definition of 'probable'

The proposed ASU would explicitly link the term 'probable' used in the probable-to-complete threshold to the ASC Master Glossary definition. 'Probable' is defined in the Master Glossary as "The future event or events are likely to occur." The term 'probable' is not currently linked to the Master Glossary defined term.

SOP 98-1 (the source of the Subtopic 350-40 guidance) stated that 'probable' had the same meaning therein as it had in FASB Concepts Statement No. 6 (CON 6), wherein it was defined and used in its conventional sense (in short, that which can be reasonably expected). However, Subtopic 350-40 never incorporated this statement from SOP 98-1 and the CON 6 probable definition was eliminated when CON 6 was superseded. Therefore, diversity in opinion has existed about which probable definition applies – i.e. that originally intended or the existing Master Glossary definition.

The FASB decided to explicitly link 'probable' in Subtopic 350-40 to the Master Glossary definition to clarify which probable definition applies and because the Master Glossary definition is generally well understood and widely used elsewhere in US GAAP. By contrast, the CON 6 definition no longer exists.

'Probable-to-complete' threshold changes

The proposed ASU would amend the existing probable-to-complete threshold by adding considerations to the evaluation and provide new illustrative examples about its application.

While the threshold itself would remain unchanged, the proposed ASU would *add guidance* to state that an entity *does not meet this threshold* if there is 'significant uncertainty' as to the software's development. What constitutes a significant development uncertainty is not defined in the proposed ASU, but the following are provided as non-exhaustive factors that may indicate such uncertainty exists.

Novel, unique, unproven functions and features or technological innovations	The software has novel, unique, unproven functions and features or technological innovations. Subtopic 985-20 has long required entities to consider the existence and resolution of 'high-risk development issues', defined consistent with the above, when assessing the 'technological feasibility' of external-use software. Therefore, this new Subtopic 350-40 assessment may be similar. [985-20-25-2]
Software's significant 'performance requirements'	The proposed ASU would require entities to determine if the software's *significant* performance requirements have been determined and are no longer subject to *substantial* revision.

	Software's 'performance requirements' would be defined as "what an entity needs the software to do (for example, functions or features)."

The proposed ASU indicates that for some internal-use software projects (e.g. to customize and implement established third-party software), it may be clear that there is no significant development uncertainty. Therefore, as a practical matter, no substantive evaluation of significant development uncertainty will occur or be necessary.

Significant performance requirements

The FASB emphasizes in the basis for conclusions that the proposed amendments do not require an entity to identify and resolve all of the software's performance requirements before it begins to capitalize software development costs but, rather, only those performance requirements that are 'significant' and *substantively* unresolved.

This means that an entity should not defer eligible cost capitalization for either (1) minor performance requirements that have not yet been determined or (2) significant performance requirements subject only to further *minor* revision. This specificity is important because agile software development frequently involves some ongoing refinement to performance requirements given its nature as an iterative user requirement-driven process.

SaaS software development

The FASB states in the proposed ASU that the 'probable-to-complete' threshold changes could bring closer alignment between the accounting for external-use software development costs – the vast majority of which are expensed as incurred by most entities – and similar costs to develop software that will be sold only on a SaaS basis (SaaS software). In particular, the additional considerations around significant development uncertainty may result in entities expensing significant portions of their SaaS software development costs if they conclude that significant development uncertainty exists – and therefore the software is not probable of completion – until relatively late in the development process.

Entities may make different judgments, even in similar circumstances, about whether software features or functions are novel, unproven or unique; what constitutes a 'significant' performance requirement; or what level of ongoing revision of a significant performance requirement is 'substantial'. Therefore, it is possible similar diversity to that which exists for external-use software under Subtopic 985-20 – i.e. most expense nearly all development costs, but some even *very similar* entities capitalize significant amounts thereof – may arise for SaaS software under the proposed amendments.

Software embedded in a tangible product

The proposed ASU would create guidance to stipulate that entities *acquiring* a tangible asset with embedded software should use a 'reasonable and consistent' method to determine whether the tangible asset is a single unit of account (inclusive of the embedded software) or whether the tangible asset should be accounted for separately from the embedded software (e.g. the tangible asset under Topic 360 on property, plant and equipment and the embedded software license under Subtopic 350-40).

The proposed ASU does not dictate any particular method to determine whether to separate the accounting for embedded software from the accounting for the tangible asset. We believe practice already exists to typically treat any embedded software that is integral (or essential) to the functionality of a tangible asset as simply *part of* that tangible asset (i.e. not as a separate unit of account). Therefore, we do not expect this amendment would significantly affect practice.

Entities *selling* tangible products with embedded software ('firmware') will continue to apply the external-use software guidance in Subtopic 985-20 to firmware development because the proposed ASU would not change the scope or requirements of Subtopic 985-20.

Financial statement presentation

New cash flow statement requirement

The proposed ASU would require cash paid for capitalized internal-use software costs to be presented separately from other investing cash outflows in the statement of cash flows. The FASB decision was based on investor outreach that indicated cash flow information related to capitalized cost is decision useful information.

The FASB considered but ultimately rejected proposing any other incremental presentation or disclosure requirements.

Financial statement presentation of expensed software development costs

The proposed ASU does not provide new guidance on how entities should present software development costs not eligible for capitalization in the income statement. The FASB considered providing new guidance around such internal-use software costs, but ultimately decided not to do so. Therefore, entities would continue to apply Subtopics 350-40 and 730-10 when determining appropriate income statement presentation and disclosure.

Website development costs and other codification amendments

Subtopic 350-50 heavily leverages the guidance in Subtopic 350-40, including a requirement to expense or capitalize based on the development stage of the website project. The proposed ASU would eliminate Subtopic 350-50 and incorporate key, non-development stage website-specific development costs guidance into Subtopic 350-40, as well as add a new illustrative example. Other Codification amendments would also be made to be consistent with the FASB's proposed amendments to Subtopic 350-40 (e.g. to Subtopic 720-45 on business process re-engineering).

Modern website development is often similar in nature and scope to software application development. Therefore, the FASB decided that separate website development cost guidance was no longer useful or needed. However, because Subtopic 350-50 has limited guidance and Subtopic 350-40 would now include the important elements from Subtopic 350-50, we do not believe the proposal would significantly change practice.

Effective dates and transition

The proposed amendments would be applied either (1) retrospectively or (2) prospectively to software costs incurred after the adoption date (i.e. on existing, in-process software projects or new projects). The retrospective approach would result in a cumulative effect adjustment to retained earnings (or other appropriate components of equity or net assets) as of the beginning of the first year presented in the entity's first set of annual financial statements issued after adoption. The prospective transition option is generally consistent with that offered to entities when adopting ASU 2018-15 on cloud computing arrangement implementation costs.

After considering stakeholder feedback on the proposed ASU, the FASB will determine the effective date of a final ASU and whether to allow early adoption.

Contributing authors

Scott Muir, P.K. Barot

KPMG Financial Reporting View

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