

# Capitalization of software development costs



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## Introduction

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In the United States, Accounting Standards Codifications 985 provides guidelines for accounting for the costs of software intended to be sold, leased, or otherwise marketed. These guidelines allow software companies to capitalize certain new product or product enhancement development costs.

To properly account for software development costs, software companies should consider and thoroughly document the following:

- 1. When is “technological feasibility” established?**
- 2. What costs can be considered for capitalization?**
- 3. Is the method used to amortize capitalized costs accurate?**

## Establishing technological feasibility

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Capitalization of costs occurs only after the technological feasibility of the product has been reached and the costs are determined to be recoverable.

According to ASC 985-20-25, which applies to software developed for sale, costs incurred to establish technological feasibility should be charged to expense when incurred. Technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to ensure the product can be produced to meet its design specifications.

### There are two ways to document that technological feasibility has been established:

- 1** If a detailed program design is used in the creation of the software, the following should be documented:
  - > The product design is complete and the company has determined it has the skills and technology necessary to complete the product.
  - > The detailed program design is consistent with the product design and the specifications in the detailed program design have been traced to the product design.
  - > High risk issues and uncertainties have been reviewed and resolved through testing.
- 2** If a detailed program design is not developed, the following should be performed/  
documented:
  - > The product design is complete, including a working model.
  - > The working model is consistent with the product design and has been tested.

Once a prototype has been built and tested to ensure it meets design specifications, the product is considered to have reached technological feasibility. In some cases, a prototype may not be built, however a full product design is completed and vetted for feasibility. The complete progress should be documented in the time logs prepared by the company.

It is critical to formally document and communicate the establishment of technological feasibility. Having a clear cutoff strengthens the controls around the accuracy of the capitalized amounts. Formalizing the approvals of the stages in writing by your research and development team and making these approvals visible to management would be considered strong documentation of technological feasibility.

## Determining the nature of costs to capitalize

ASC 985-20-25-3 states, "The costs of producing product masters incurred subsequent to establishing technological feasibility shall be capitalized." Those costs include coding and testing performed subsequent to establishing technological feasibility.

Often, the majority of the capitalized costs within a company are a portion of the salaries paid to the programmers and developers. The portion that is capitalized should relate to the hours that are spent on the software product in the production phase. Tasks and activities performed by each employee should be documented and maintained in time logs.

## What is or is not permissible?

Many software companies have difficulty determining which software development costs can be capitalized. Typically, those that add future value can be capitalized and those that do not are expensed.

It is permissible to capitalize an allocable portion of indirect costs, such as overhead related to programmers and the facilities they occupy. It is not permissible to allocate any general or administrative expenses to the product.

An example of the nature of costs to be [expensed vs. capitalized](#) is detailed below.

Expense	Capitalize
<ul style="list-style-type: none"><li>&gt; Feasibility</li><li>&gt; Prototyping</li><li>&gt; Analysis</li><li>&gt; High-level work associated with decision-making</li><li>&gt; Training</li><li>&gt; Product maintenance</li><li>&gt; G &amp; A expenses</li></ul>	<ul style="list-style-type: none"><li>&gt; Upgrades and enhancements to increase functionality</li><li>&gt; Salaries</li><li>&gt; Cost of materials</li><li>&gt; Contract labor</li><li>&gt; Overhead related to programmers</li><li>&gt; Purchased software incorporated into software being developed</li></ul>

Capitalization of costs must stop once the product is available for customers. Organized, detailed, and thorough records of costs incurred, labor hours and labor rates, overhead allocations, and project milestones are very important to properly document the amount capitalized.

## Amortizing costs

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Amortizing capitalized software costs must begin once the product is available for sale. Annually, the amount of amortization should be the greater of:

- 1** The ratio of current product revenue to total product revenue expected, including post-contract customer support (PCS)
- 2** The amount calculated on a straight-line method over the remaining economic life of the product

These calculations should be updated for new estimates of remaining revenue and expected life each year, and the amounts expensed may vary from year to year.

In addition to amortization, the unamortized capitalized costs should be evaluated for impairment at each balance sheet date. If the net realizable value is less than the remaining unamortized costs, the capitalized software costs are considered impaired. When determining the net realizable value, costs of maintaining and providing support should be considered in addition to expected revenues.