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Capitalization of Software-Related Development Costs

Background
A Company has developed and patented technologies that are used in various software applications.

The Company engages in continuous development of its technologies, and obtains patents for intellectual property it develops. The original technology was developed internally by the Company.

The Company recently entered into a product development agreement with another company for the development of a new generation of its current patented technology; this new generation will include additional features, enhanced functionality, and will feature a higher level of integration, which will reduce future implementation and licensing costs for customers who use the Company's technology.

The development work to be performed is necessary for the Company to perform in order to enhance its current technology.

Issue
Can the development portion of the costs the Company incurs to further improve and adapt its technologies to alternative uses be capitalized?

Authoritative Guidance
ASC 730 (codification of FAS 2) addresses research and development costs in general. ASC 730-10 states that research and development costs generally must be expensed as incurred, with the exception of certain development costs related to software to be sold, leased, or marketed to others. Such software-related development costs are subject to the guidance in ASC 985-20, which in effect is more industry-specific guidance.

As previously stated, ASC 985-20 (codification of SFAS 86, 08/95) applies to costs of software to be sold, leased, or marketed to others. ASC 985-605 (codification of SOP 97-2) addresses software revenue recognition. ASC 350-40 (codification of SOP 98-1) addresses software developed or obtained for internal use, which does not apply in this case.

Per ASC 985-20, there are two points to consider in the software development timeline.
(A) When the technological feasibility is established

(B) When the product is available for general release to customers

Per ASC 985-20, costs of software to be sold, lease, or market to others should be accounted for as follows:

1. Costs incurred up to the point where technological feasibility is established should be expensed as incurred (ASC 985-20-25-1), as required by ASC 730-10
2. Costs incurred after technological feasibility is established and before a product is available for general release to customers, such as costs related to product masters, should be capitalized (ASC 985-20-25-3); this stage includes coding and testing performed subsequent to establishing feasibility
3. Costs incurred after the product is available for general release to customers, such as maintenance and support, should be expensed (ASC 985-20-25-6)

NOTE: Per ASC 985-20-25-4, software production costs for software that is to be used as an integral part of a product should only be capitalized when BOTH of the following conditions have been met:

1. Technological feasibility has been established
2. All R&D for other components of the product has been completed

NOTE: Determining whether there is an alternative use for software becomes a consideration when accounting for costs of <u>purchased</u> software; costs incurred for purchased software that has an alternative future use should be capitalized. Costs incurred for purchased software that has no alternative use should be accounted for in the same manner as internal development costs.

Per ASC 985-20-25-5, an entity may capitalize an allocated amount of indirect costs, such as overhead related to programmers and the facilities they occupy. However, an allocation of general and administrative expenses is not appropriate because those costs relate to the period in which they are incurred.

Per ASC 985-20-25-6, Costs of maintenance and customer support should be expensed when related revenue is recognized or when those costs are incurred, whichever occurs first.

Per ASC 985-20-35-2 states that, once capitalized, software should be amortized on a product by product basis, starting when the product is available for general release to customers. Amortization should be recorded as the higher of straight-line method amortization, or an amount based on the ratio of current revenue and total expected revenue.

Once capitalized, management should regularly perform tests of impairment. If the net realizable value is less than the unamortized balance, then the unamortized balance should be written down to the NRV. The difference is recognized as an expense, and the write-down is not reversed in subsequent periods.

Application of Authoritative Guidance

It appears that the developments costs in question are software development costs, because such costs have been deemed necessary by the Company in order to adapt its technology to future uses, and to maintain its competitive edge in the industry. In other words, we believe the issue is not whether the costs should be expensed per ASC 730-10, but whether they qualify to be capitalized under ASC 985-20.

Therefore, we believe that the provisions of ASC 730-10 do not apply in this case, and that the Company should use the guidance in ASC 985-20-25-4 to determine whether or not such software-related developments costs should be capitalized.

If the Company concurs that ASC 985-20-25-4 as described above applies in this case, then the Company should perform the following steps to properly account for the development costs related to its patented technology.

1. Make its best attempt to determine where such costs fall in its product development timeline
2. Verify whether other components of the potential product are technologically feasible
3. If the costs are incurred between technological feasibility and product release to the general public, and the other components are technological feasible, capitalize such costs and amortize those costs
4. If the costs will not be incurred between technological feasibility and product release to the general public, and/or the other components are not technological feasible, immediately expense such costs

Conclusion

We believe that ASC 985-20 applies in this case, and that the primary question the Company must answer is whether technological feasibility has been established. At the same time, given that its technology is used as a component in various products, the Company should also determine whether the other components to be used in the final product (with the exception of the integrated circuit under development) are all technologically feasible before capitalizing such development costs.

The Company does not appear to acquire any asset right in its agreements; the Company may, however, develop software that possesses the attributes of an asset or assets per ASC 985-20. If the Company has the ability to use such an asset (or modify it in ways that would not be considered significant), the Company is in possession of an asset during the period after technological feasibility is established and before that asset (either alone or as a component) is made available for sale to the general public.

If the Company determines that technological feasibility has been established and that the other components in the product are technologically feasible, we believe it is appropriate for the Company to capitalize such development costs.

To reiterate, because its technology is a component of a product, the Company should only capitalize costs if all research and development activities for the other components (with the exception of the circuit in design) of the product have been completed.