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Software startups: Don't overlook capitalized software

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Dealing with many startup software companies over the years, we have seen more than a few oversights of an important aspect of financial reporting during the fast-paced incubation period.

The oversight pertains to the rules for capitalizing software costs, a financial reporting requirement of which many startups are either unaware, or misapply.

For those unfamiliar, capitalizing costs means recognizing costs over a period of time (i.e., through depreciation or amortization) rather than expensing them as they occur.

The rules for capitalizing software costs, which apply to both perpetual licensing and SaaS products, may appear cumbersome, but can be broken down into three easy steps: (1) determining which capitalization "bucket" the software falls into, (2) identifying which costs to capitalize, and (3) amortizing the costs.

Step 1 - Determining the capitalization bucket.
Software to be capitalized falls into one of two classification buckets: (a) internal use software (ASC 350) or (b) software to be sold, leased or otherwise marketed (ASC 985). If (i) the software is acquired, internally developed or modified solely to meet the entity's internal needs, and (ii) during development or modification, no substantive plan exists or is developed to market the software externally, it is classified as internal use software. Otherwise, it falls into the ASC 985 bucket.

Step 2 - Identifying which costs to capitalize.
The next question is: what, when and how to capitalize costs. The answer to that is: "it depends."
For internal use software, development is viewed in three stages:

Preliminary project stage – This includes things like evaluating alternatives, determining technology needed, and formulating concepts. During this phase, costs should be expensed as incurred.

Application development stage – This can include coding as well as software configuration and interfacing, hardware acquisition and installation, among others. The focus here is direct costs including external and internal costs or services, as well as any interest incurred. Costs in this phase are capitalized.

Post-implementation / operation stage – Costs here are expensed as incurred and can include training, maintenance and support.

For software marketed externally, the three stages of development are slightly different:

(i) Development planning – Costs are expensed as they are incurred.

(ii) Technological feasibility– Direct and indirect costs, including the cost of producing the product masters, are capitalized. Accounting guidance indicates that technological feasibility has been achieved when the company has completed all activities necessary to determine that the product meets design specifications. The company is required to provide evidence that technology feasibility has been established based on whether or not there is a detailed program design for the software.

(iii) Post-release costs – Costs for routine maintenance are expensed as incurred. The company can and quite often will make enhancements to the software, at which time they may be capitalized. When this occurs the rules revert back to (i) development planning.

Step 3 - Amortizing the capitalized software costs.
What comes next? If you are an internal use company, costs are amortized over the estimated useful life of the software (generally on a straight-line basis), which is often relatively short due to the speed of technological change.

If you are marketing the product externally, costs are amortized over the greater of (a) the ratio of the product's current gross revenues to the total of current and expected gross revenues, or (b) the straight-line method, computed by dividing the remaining unamortized capitalized cost by the estimated remaining economic life of the product.

Determining the different phases of a software project entails a great deal of subjectivity.
The onus is on management to closely evaluate the timing and nature of costs incurred in their new software products and services to arrive at the appropriate accounting treatment.

With insurtech, health-tech and fintech driving a software company renaissance here in Connecticut, the importance of accurate financial reporting is paramount for many new and rising entrepreneurs in our state.

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