

University of California

GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*

Issues Resolution Memo No. 51.2

INTANGIBLE ASSETS—SOFTWARE ISSUES

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1. INTRODUCTION

GASB Statement No. 51 requires intangible assets to be classified and reported as capital assets. Examples of intangible assets include easements, water rights, timber rights, copyrights, patents, trademarks, and computer software. Intangible assets can be purchased or licensed, acquired through non-exchange transactions, or internally-generated. The University must implement the requirements of the Statement for the fiscal year beginning July 1, 2009, with restatement of the previous fiscal year.

This IRM provides guidance on the treatment of computer software, including the capitalization of internal development costs. This IRM supersedes IRM 11, *Approach to Software*, dated March 31, 2003.

2. STATEMENT NO. 51: DEFINITION, CLASSIFICATION AND TREATMENT OF SOFTWARE COSTS

a. *Intangible Assets*

Statement No. 51 defines intangible assets as assets that:

1. lack physical substance,
2. are non-financial in nature, and
3. have initial useful lives extending beyond a single reporting period (one year).

Intangible assets can be purchased or licensed, acquired through non-exchange transactions, or internally-generated. The Statement lists easements, patents, trademarks and computer software as examples of intangible assets.

b. *Internally-Generated Software*

The Statement identifies computer software as a common type of intangible asset that is often internally-generated. Computer software is considered internally-generated if it is developed in-house by University employees or by a third-party contractor on behalf of the University. Commercially available software that is purchased or licensed by the University and modified using more than minimal incremental effort before being put into operation also should be considered internally-generated for purposes of Statement No. 51. For example, licensed financial accounting software that the University modifies to add special reporting capabilities would be considered internally-generated. (Paragraph 9)

Outlays incurred for the development of internally-generated software should be capitalized only upon the occurrence of all of the following:

- Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the intangible asset upon the completion of the project (Paragraph 8a)
- Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity (Paragraph 8b)
- Demonstration of the current intention, ability, and presence of effort to complete or, in the case of a multiyear project, continue development of the intangible asset. Evidence of intention, ability, and presence of effort to complete the intangible asset may include budgetary commitments for funding the project, reference to the project in strategic planning documents, commitments with external parties to assist in the creation of the intangible asset, and efforts to secure the University's legal rights to the projects. (Paragraphs 8c & 54)

Only outlays incurred subsequent to meeting the above criteria should be capitalized. Outlays incurred prior to meeting those criteria should be expensed as incurred.

The Statement provides the following additional guidance specific to internally-generated software.

The activities involved in developing and installing internally-generated computer software can be grouped into the following stages:

- *Preliminary Project Stage.* Activities in this stage included the conceptual formulation and evaluation of alternatives, the determination of the existence of needed technology, and the final selection of alternatives for the development of the software. (Paragraph 10a)
- *Application Development Stage.* Activities in this stage include the design of the chosen path, including software configuration and software interfaces, coding, installation to hardware, and testing, including the parallel processing phase. (Paragraph 10b)
- *Post-Implementation/Operation Stage.* Activities in this stage include application training and software maintenance. (Paragraph 10c)

Data conversion should be considered an activity of the application development stage only to the extent it is determined to be necessary to make computer software operational, that is, in condition for use. Otherwise, data conversion should be considered an activity of the *Post-Implementation/Operation Stage*.

Outlays incurred related to the development of an internally-generated computer software should be capitalized when both of the following occur:

- a. The activities noted in the *Preliminary Project Stage* are completed (Paragraph 11a)
- b. Management implicitly or explicitly authorizes and commits to funding, at least currently in the case of a multiyear project, the software project. (Paragraph 11b)

Outlays associated with activities in the preliminary project state should be expensed as incurred. For commercially available software that will be modified to the point that it is considered internally-generated, (a) and (b) above generally could be considered to have occurred upon the University's commitment to purchase or license the computer software.

Once the criteria in (a) and (b) above have been met, outlays related to activities in the *Application Development Stage* should be capitalized. The capitalization of such outlays should cease no later than the point at which the computer software is substantially complete and operational. (Paragraph 12)

Outlays associated with activities in the *Post-Implementation/Operation Stage* should be expensed as incurred. (Paragraph 13)

The activities within the stages of development (*Preliminary Project Stage*, *Application Development Stage*, *Post-Implementation/Operation Stage*) may occur in sequence different from that listed above. The recognition guidance for outlays associated with the development of internally-generated computer software set forth above should be applied based on the nature of the activity, not the timing of its occurrence. For example, outlays associated with application training activities that occur during the application development stage should be expensed as incurred. (Paragraph 14)

Outlays associated with an internally-generated modification of computer software that is already in operation should be capitalized in accordance with the criteria in (a) and (b) if they qualify as Application Development Stage activities and results in any of the following:

- An increase in the functionality of the computer software, that is, the computer software is able to perform tasks that it was previously incapable of performing (Paragraph 15a)
- An increase in the efficiency of the computer software, that is, an increase in the level of service provided by the computer software without the ability to perform additional tasks (Paragraph 15b)
- An extension of the estimated useful life of the software. (Paragraph 15c)

If the modification does not result in any of the outcomes, the modification should be considered maintenance, and the associated outlays should be expensed as incurred.

3. UC'S CURRENT CLASSIFICATION AND TREATMENT OF SOFTWARE

The University's policy for capitalization of property is established in the University Accounting Manual, Chapter P-415-10, *Capitalization of Property, Plant and Equipment*. It establishes the following basic capitalization framework:

Capital assets include all tangible and intangible assets acquired, fabricated, or constructed for use in the operation of the institution, whose use or consumption will cover more than one year. It does not include assets acquired as investments or for sale. The University of California (UC) classifies its capital assets into the following categories for reporting purposes:

- Land
- Infrastructure
- Buildings and improvements (including fixed equipment)
- Equipment (including intangible assets and software)
- Libraries and collections
- Special collections
- Intangible assets (including computer software)
- Construction in progress

Additional guidance for the classification and treatment of software was provided in Issue Resolution Memo (IRM) No. 11, *Approach to Software*. The IRM was developed during the University's implementation of GASB Statement No. 34 and 35, and generally followed the approach prescribed in the Statement of Position (SOP) 98-1, *Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*, issued by the Accounting Standards Division of the American Institute of Certified Public Accountants (AICPA) on March 4, 1998. The SOP provided guidance on accounting for the costs of computer software developed or obtained for internal use (i.e., not to be sold or otherwise marketed). While the SOP technically does not apply to public institutions, the basic principles are applicable; thus, it was considered in the development of the University's accounting policies. The guidance established in IRM No. 11 have been updated and incorporated into this IRM as Appendix 1.

In brief, the University report software as a category of capital assets, separate from intangible assets. They are classified into two categories as follows:

- *Software with unit or system cost of \$10 million or less* is capitalized and amortized over three years. Only the external cost of acquisition is capitalized for this class of software.
- *Software with unit or system cost > \$10 million* is capitalized and amortized over seven years. The capitalized cost of this class of software includes internal and external cost of acquisition and development.

4. STATEMENT NO. 51 IMPLEMENTATION APPROACH FOR SOFTWARE

In general, the University already complies with the requirements of Statement No. 51. However, the University has purposely limited the capitalization of internal development costs to reduce the burden of tracking and recording these costs. The impact of this approach on the annual consolidated financial statements is immaterial. The internal development cost, whether expensed in the year as incurred or capitalized and amortized over three or seven years will result in roughly the same amount of annual expense if the total cost of internal development remains constant from year to year. However, to address the additional guidance provided by GASB Statement No. 51, UC will change the definitions and treatment of the two classes of software to further reduce any potential impact on its consolidated financial statements.

Changing the classification threshold to \$5 million will further minimize the internal development costs that are not capitalized. This is a realistic and manageable compromise for implementation of the GASB requirement. The approach has been discussed with PwC and has received their concurrence.

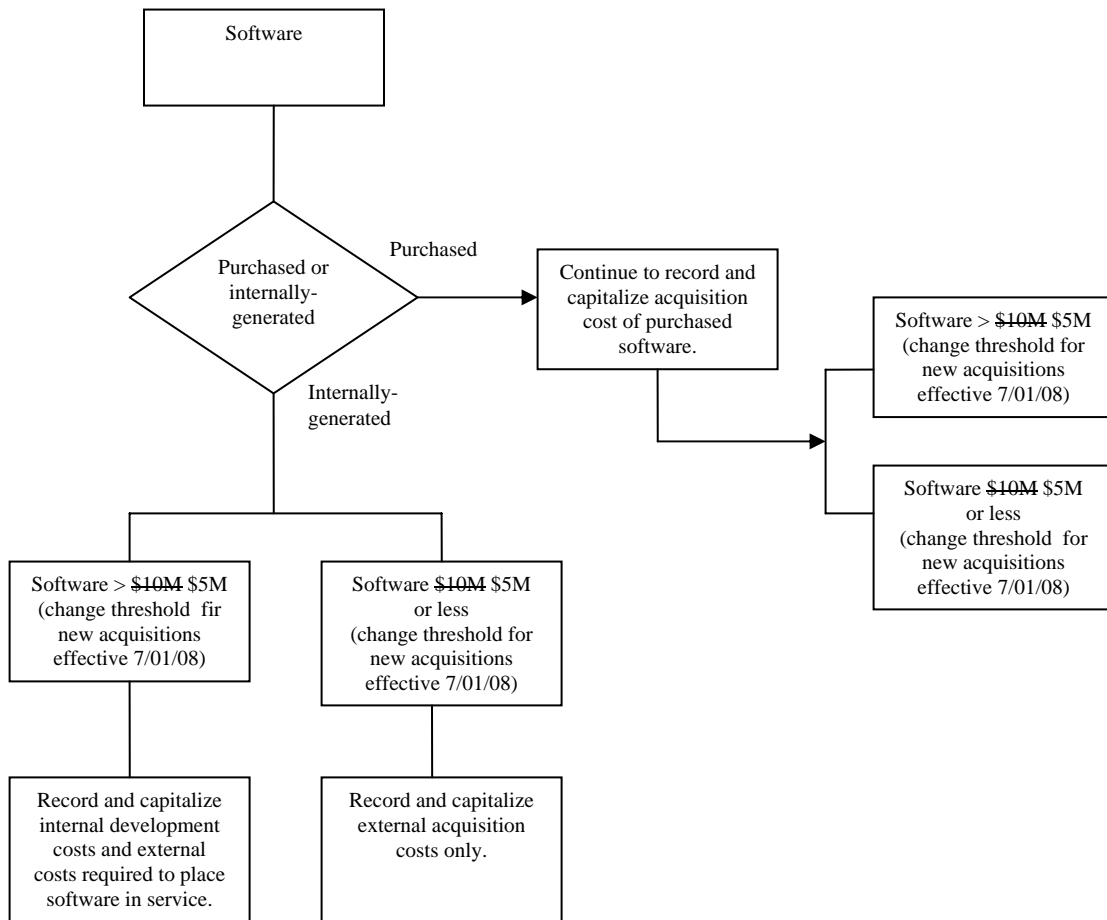
Beginning in the fiscal year 2009–2010, UC will report software as a category of intangible assets. It will also revise its classification of software as follows:

- *Software with unit or system cost of \$5 million or less (Software \leq \$5M) will be capitalized to include external acquisition costs only. The costs will be amortized over three years.*
- *Software with unit or system cost of over \$5 million (Software $>$ \$5M) will be capitalized to include external acquisition costs and internal development costs. The costs will be amortized over seven years.*

a. GASB Statement No. 51 Classification and Transition Flowchart—Software

The University proposes to change its definition of “small” and “large” software. The current threshold of \$10M will be changed to \$5M. The change in the threshold will affect the useful life assigned to the software with cost between \$5M and \$10M. It will also affect the threshold for capitalization of internal development costs. The change in threshold will enhance the University’s compliance with the intent of GASB Statement No. 51, without creating an unmanageable requirement to capitalize immaterial internal development costs for software.

A unique CAAN number may be assigned to identify each item or system of software. Alternatively, a single CAAN number may be assigned to identify all software ~~\$10M~~ \$5M or less and another single CAAN number may be assigned to all software > ~~\$10M~~ \$5M.



5. IMPLEMENTATION AND TRANSITION ISSUES

The overall implementation plan for the Statement is provided in IRM 51.1, *Overview of Statement No. 51 and the University’s Approach for Implementation*. The issues discussed below are implementation and transition issues specific to software.

a. Review of historical data

Statement No. 51 must be implemented retroactively and reported in the financial statement for the year beginning FY 2009–2010, with restatement of FY2008–2009. However, the Statement also permits the prospective implementation for certain categories of intangible assets, including internally-generated assets.

The University will not gather historical costs for software. Historical data for internally-generated software is not required. Historical data for purchased software is required by the Statement; however, since UC has been capitalizing software costs since 2002, any software acquired before 2002 will be fully depreciated by July 1, 2009 (based on a maximum life of seven years). While software acquired in 2001 will have amortization expense for the 2008–2009 year (the restatement year), the impact on the consolidated statement will be immaterial.

Summary of Historical Data Required for Implementation of the Statement

Category of Intangible Assets / Software	Historical Data Required
Software	
Purchased or Gifted	Yes – but UC has gathered data since July 1, 2002. <u>No additional data will be collected during the transition period.</u>
Internally-Developed	No – historical data is not required by Statement No. 51

b. Assignment of CAAN Numbers

A unique Corporate Asset Account Number (CAAN) must be assigned and used to record each item of intangible asset unless otherwise noted. UC will inventory software with unit or system cost of \$5 million or less, in aggregate and not on an itemized basis. Software greater than \$5 million will be inventoried either in aggregate or on an itemized basis as appropriate, to be determined by the campus. However, each campus must, at a minimum, maintain separate CAANs for each classification of software.

Summary of CAAN Assignment Requirements

Category of Intangible Assets / Software	CAAN Requirement
Software	
Acquisition cost \$5 million or less	Unique CAAN per item should not be assigned. A single CAAN should be used for all software in this category.
Acquisition cost more than \$5 million	Campuses may assign unique CAAN per item or system, or may use a single CAAN for all software in this category. Use of a separate CAAN per item or system will enable the campus to assign specific useful life for amortization.

c. Restatement of FY 2008–2009

For software, the University is already in general compliance with Statement No. 51. The incremental changes that will be made are very minor. It should not be necessary to gather the incremental data for restatement of FY 2008–2009 in FY 2009–2010. UC will implement these changes for enhanced compliance with Statement No. 51 prospectively in FY 2009–2010.

6. NEXT STEPS

- Beginning July 1, 2009, campuses will begin to apply the new definition and classifications for software.

APPENDIX 1: UPDATE AND REISSUE OF IRM 11, *APPROACH TO SOFTWARE*

The information contained below was originally issued on March 31, 2003. It is being reissued as an Appendix to IRM 51.2 .

Externally Purchased Software, Software License Costs, and Other External Costs

- The University will expense purchased computer software costs and associated external costs (e.g., external consultants) required to make the software operational that are less than \$5,000¹ ~~\$1,500~~ per copy. As such, consolidated software purchases will not be capitalized where the cost per copy is less than \$5,000 ~~\$1,500~~ per copy, even though the total cost is \$5,000 or more ~~greater than \$1,500~~.
- Campuses may create an object code to record purchased software expenses that are less than ~~\$1,500~~ \$5,000. However, the object code must roll-up to the corporate object code 8000—Supplies and Materials.
- Effective July 1, 2001, the University will capitalize and depreciate purchased software costs if the software purchase price and associated external costs (e.g., external consultant costs) required to make the software operational are ~~\$1,500~~ \$5,000 or more per copy. This applies to the application development costs as defined in the AICPA’s SOP. The preliminary project costs and the post-implementation / operation costs will be expensed.
- Software costs included with the purchase cost of hardware (not separately identified on the vendor’s invoice) will be capitalized as hardware costs.
- Annual software license fees and maintenance costs will be expensed, whether the fees are paid monthly or annually. This applies to software “leases” where the University does not own the software, but may operate it for as long as the license/maintenance fees are paid.
- Licenses where no period is mentioned (i.e., perpetual licenses) are capitalized if the cost per license is ~~\$1,500~~ \$5,000 or more and the useful life of the license exceeds one year.
- The University will depreciate software costs on an aggregated basis beginning in the year after the costs are capitalized.
- Campuses will capitalize software expenses at June 30. The University will use the previous June 30 balance to calculate depreciation expense and the balance of accumulated depreciation to report in the financial statements of the following June.

¹ The capitalization threshold for software was increased to \$5,000 beginning on July 1, 2004.

- *Example—*
 - At June 30, 2002, campuses will capitalize purchased software expenditures that are greater than ~~\$1,500~~ \$5,000 and less than \$10 million (see next section for approach to software projects greater than \$10 million).
 - During FY 2002-03, OP will use the June 30, 2002 capitalized balances to calculate the depreciation expense and accumulated depreciation to be reported on the FY 2002-03 financial statements.
 - Software costs will be depreciated over three years (software projects greater than \$10 million will be depreciated over seven years).
 - Campuses will track annual software cost increments and depreciate each increment over three years. After three years, the costs, along with the accumulated depreciation will be written off.
 - Software capitalization for software purchases between ~~\$1,500~~-\$5,000 and \$10 million will be based on the expenses recorded in the object code, 9235 (Software Projects to be Capitalized Less Than \$10 Million).
 - In order to comply with the requirements of OMB Circular A-21, campuses will be required to identify capitalized purchased software that was obtained with sponsored funds. Funding source information will be identified through the fund number associated with the purchases and preserved in the plant asset account.
 - All computer software training costs will be expensed as incurred.
 - Costs related to maintenance, enhancements, or upgrades will be expensed as incurred.
 - Except as described below, internal development costs will be expensed as incurred.

Policy Exception Applicable to “Projects” Expected to be Greater than \$10 Million

- If total software “project” costs [all AICPA SOP stages (excluding hardware costs), preliminary project, application development, and post-implementation / operation] are expected to be greater than \$10 million, the University will capitalize and depreciate the internal development costs of staff dedicated to the project in addition to the software purchase/development costs and external costs required to make the software operational. Only the application development stage expenditures will be capitalized and depreciated.

- *Definition of “Project”*

A “project” is defined as a system or series of modules developed as an integrated application designed to deliver a comprehensive application or product suite and whose development costs cannot be separated by component. A software component, module, or system is developed independently of another application and can function on its own without requiring integration of other software and whose costs can be discretely identified (e.g., payroll system developed as a module subsequent to the development of a larger system). A project is managed as a whole and has a fixed beginning and end.

- *Costs to be Capitalized*

“Project” costs that will be capitalized and depreciated include only the software application development costs as outlined in the AICPA’s SOP:

- Design of chosen path, including software configuration and software interfaces
- Coding
- Installation to hardware
- Testing, including parallel processing phase “Project” costs include the external costs required to make the software operational (excluding hardware), as well as dedicated internal development staffing costs. Dedicated internal development costs are capitalized only in the application development stage of a project (as described in the AICPA’s SOP) and are defined as:
 - ◇ The costs of materials and external services that can be directly attributable to a project;
 - ◇ Payroll and payroll-related costs (e.g., benefits) for employees who are dedicated to a project; and
 - ◇ Other costs directly attributable to a project (e.g., travel expenses incurred by staff in their duties directly associated with the project).

- *Examples of “Projects”*

The following examples provide illustrations of software projects

- *Example 1*—A campus installs a new stand-alone financial aid system, i.e., no other system or module is being developed or installed at the same time or has been approved for funding at the same time. Based on the operational definition of a software development project, this would be considered a single project.

- *Example 2*—A campus installs a new student information system that consists of multiple functional modules, e.g., financial aid, registration and admission, etc. The modules are installed sequentially or with overlapping schedules and have received approval and/or funding support for the system as a whole. Based on the operational definition of a software development project, the entire student information system would be considered a single project.
- *Example 3*—A campus installs multiple applications systems (e.g., student system and financial system) that have been approved and/or funded at the same time. Based on the operational definition of a software development project, these would be considered separate projects.
- *Examples For Determining When “Project” Costs Exceed \$10 Million*

Below are illustrations of when software, external and internal application development costs should be capitalized.

- *Example —Total Project Costs \$8 million*

External Software \$5 million
External Consultant \$3 million
Internal Development \$0

In this example, the campus would capitalize and depreciate the application development costs related to \$8 million project because the total costs are greater than the established ~~\$1,500~~ \$5,000 threshold.

- *Example 2 -- Total Project Costs \$9 million*

External Software \$5 million
External Consultant \$3 million
Internal Development \$1 million

In this example, the campus would again capitalize and depreciate the application development costs related to the software development and external consultant costs. However, costs related to internal development would not be capitalized because the total project cost (\$9 million) does not exceed the \$10 million threshold.

□ *Example 3 -- Total Project Costs \$12 million*

External Software \$5 million

External Consultant \$3 million

Internal Development \$4 million

In this example, the campus would capitalize the application development costs of the \$12 million total project costs because the project exceeds the \$10 million threshold.

- For projects where total costs are expected to be greater than \$10 million, campuses are encouraged to discuss project components with UCOP Financial Management to assure appropriate and consistent treatment.
- For projects expected to be less than \$10 million but actual costs exceed \$10 million, the University will not make prior year adjustments to capitalize these projects. However, OP encourages campuses to review project costs at the end of the first year to determine whether expected total project costs need to be reassessed.
- Campuses will record software project costs that are greater than \$10 million in object code 9230 (Software Projects to be Capitalized Greater Than \$10 Million).
- At June 30, campuses will be required to eliminate expenditures for software projects greater than \$10 million from current funds by:
 - capitalizing projects or parts of projects that have been completed; or
 - reclassifying current fund expenditures to work-in-progress accounts.
- At December 31, the University will use the June 30 balance to identify the annual increment(s) to be depreciated. Software costs for projects greater than \$10 million will begin to be depreciated in the year after they are capitalized.
- In order to comply with the requirements of OMB Circular A-21, campuses will be required to identify funding sources for software development costs (federal, non-federal, and all other). Funding source information will have to be preserved in work in-progress accounts, as well as in the plant asset accounts (refer to IRM No. 12, Part 2, *Specifications for Electronic Files Required by UCOP—Prospective Data* and IRM No. 15, *Eliminating Capital Fund Expenditures from Current Funds* for additional information).
- Capitalized software costs for projects greater than \$10 million will be written off after seven years, along with the accumulated depreciation.
- All maintenance, enhancements, upgrade, and training costs will be expensed as incurred.