

Technical Line

FASB – final guidance

A closer look at the FASB's amended guidance on accounting for internal-use software costs

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What you need to know

- ▶ The FASB's amendments modernize how companies account for internal-use software costs. They remove all references to project stages in ASC 350-40 and clarify the threshold entities apply to begin capitalizing costs.
- ▶ Entities may need to apply more judgment to determine whether and when to begin capitalizing software costs and will have to make sure any significant development uncertainty is resolved before capitalization begins.
- ▶ The guidance specifies that the property, plant and equipment disclosure requirements under ASC 360-10 apply to capitalized software costs accounted for under ASC 350-40, regardless of how those costs are presented in the financial statements.
- ▶ The guidance, which applies to all entities, is effective for fiscal years beginning after 15 December 2027, and interim periods within those fiscal years. Entities may apply the guidance using a prospective, retrospective or modified transition approach. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) amended ASC 350-40, *Intangibles – Goodwill and Other – Internal-Use Software*, to modernize the accounting for costs related to internal-use software. Accounting Standards Update (ASU) 2025-06¹ (the ASU) removes all references to project stages throughout ASC 350-40 and clarifies the



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threshold entities apply to begin capitalizing costs. The amendments require entities to determine whether significant development uncertainty exists when evaluating if the software project is probable of completion and that it will be used to perform the function intended.

The guidance also specifies that the disclosures under ASC 360-10, *Property, Plant, and Equipment – Overall*, apply to capitalized software costs accounted for under ASC 350-40, regardless of how those costs are presented in the financial statements.

The amendments address stakeholder feedback that the current guidance for software costs is outdated and not relevant given the evolution of software development. Many entities that develop internal-use software have shifted to using an incremental and iterative development method (such as the agile method) from a prescriptive and sequential development method (such as the waterfall method). The current internal-use software accounting guidance does not address software developed using an incremental and iterative method.

This publication highlights the accounting for internal-use software after the adoption of ASU 2025-06 and provides key considerations for entities as they prepare to implement the new guidance. As summarized below, the guidance impacts the recognition and disclosure requirements in ASC 350-40.

Significant changes from ASU 2025-06	No significant changes from ASU 2025-06
<ul style="list-style-type: none"> ✓ Recognition ✓ Disclosures 	<ul style="list-style-type: none"> ✗ Overview ✗ Scope ✗ Initial measurement ✗ Subsequent measurement ✗ Presentation matters

The most significant changes relate to the recognition threshold and are intended to address stakeholder feedback regarding challenges applying the current guidance, including determining when to begin capitalizing internal-use software costs. The new guidance more closely aligns with the recognition requirements in the external-use software guidance.

While there are changes to the capitalization criteria, the Board said in the ASU's Background Information and Basis for Conclusions that "capitalization of internal-use software costs generally will not change significantly for most types of software under the amendments."² Additionally, the Board said that it expects the amendments could result in a decrease in software capitalization for the development of software to be provided through a cloud computing arrangement.

The ASU does not change the guidance on external-use software in ASC 985-20, *Software – Costs of Software to Be Sold, Leased, or Marketed*.

Accounting for internal-use software costs

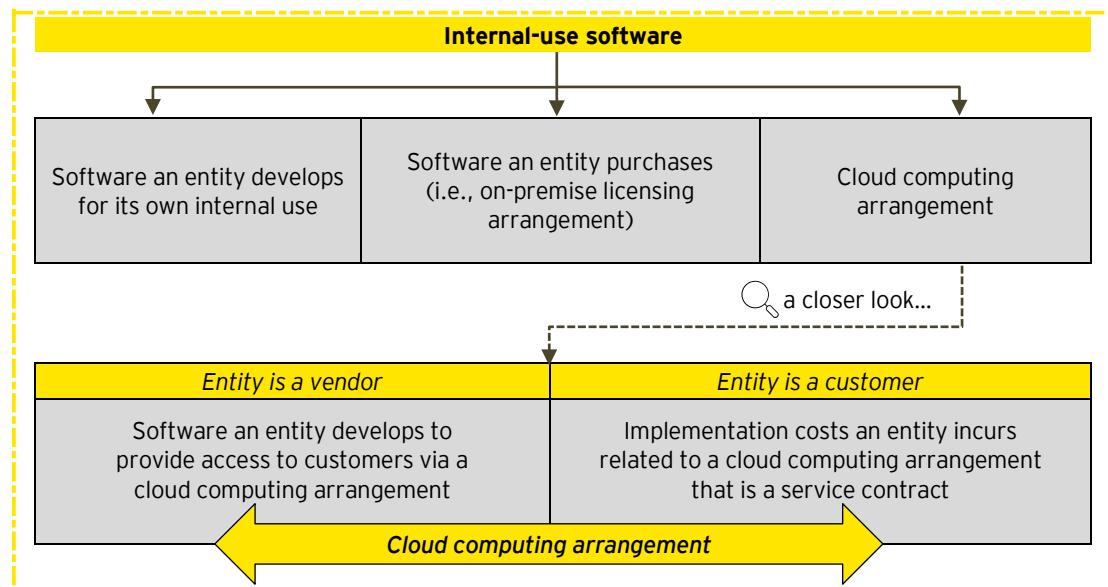
Scope

The amendments in ASU 2025-06 do not introduce significant changes to the scope guidance in ASC 350-40. Software needs to have both of the following characteristics to be considered internal-use software subject to ASC 350-40:

- The software is internally developed, acquired or modified solely to meet the entity's internal needs.
- During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

If a substantive plan exists or is being developed to market the software externally, costs to develop the software should be accounted for under ASC 985-20 as software to be sold, leased or otherwise marketed.

The table below summarizes the types of software development projects that are in the scope of ASC 350-40, including projects to develop an entity's own software or purchase software as well as software accessed via cloud computing arrangements.³ Cloud computing arrangements have additional complexity, including considerations for when an entity is a vendor (i.e., develops software) or a customer (i.e., purchases software) in a software arrangement. Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service and other hosting arrangements.



Cloud computing arrangement when the entity is a vendor

Generally, an entity that is a vendor in a cloud computing arrangement applies the internal-use software guidance consistent with software internally developed or purchased, unless there is a license granted with the arrangement, which occurs if both of the following criteria are met:

- ▶ The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- ▶ It is feasible for the customer to run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

If both of these criteria are met, the costs are not in the scope of ASC 350-40 and the vendor applies the external-use software guidance in ASC 985-20 to the software development costs associated with a cloud computing arrangement.

Cloud computing arrangement that is a service contract (the entity is a customer)

An entity that is a customer may enter into a cloud computing arrangement with a third-party vendor to access and use cloud-based resources. Customers that gain access to software in a cloud computing arrangement account for the software as internal-use software only if the arrangement includes a software license. A customer in a cloud computing arrangement that has a software license accounts for the software license under the internal-use software guidance in ASC 350-40 if the same two criteria as outlined above are met.

If the arrangement includes a software license, the costs incurred to acquire the license, as well as the costs incurred to modify the licensed software or other internal-use software, are capitalized if they meet the amended criteria under ASC 350-40. If the arrangement does not meet the criteria for a software license, the customer accounts for the arrangement as a service contract and only qualifying implementation costs are capitalized under ASC 350-40. That is, a customer in a cloud computing arrangement applies the capitalization guidance described below to account for (1) software costs (if the arrangement includes a software license) or (2) implementation costs (if the arrangement is a service contract).

A customer in a cloud computing arrangement should be mindful that there are different presentation requirements depending on whether the arrangement includes a software license or is a service contract. Refer to the *Presentation and disclosure* section below for a description of the differences.

Question 1

What is the unit of account for purposes of applying the guidance?

A software project is the unit of account when applying the capitalization requirements in ASC 350-40. However, the guidance does not specifically define what constitutes a software project.⁴ Entities will need to apply judgment to determine the appropriate unit of account based on their facts and circumstances.⁵ This will be especially important with software developed under the agile development method, which typically involves breaking down software development into a focused set of objectives (e.g., a new feature or elements of a new feature) that are developed simultaneously in a series of short development iterations, or sprints.

Entities often develop more than one component or module in connection with an internal-use software development project. In this situation, entities may determine the unit of account by evaluating whether there is interdependent functionality with the modules or components. For example, an entity may develop an accounting system that includes a general ledger, an accounts receivable subledger and a payroll subledger. The entity may determine each module or component has independent functionality, and therefore, each module or component could be considered a separate unit of account. In contrast, if the functionality of individual modules or components are interdependent, they could be considered as one unit of account. However, determining the unit of account may require significant judgment and could be based on other factors. We believe that the approach used by an entity should be applied consistently to similar software development projects.

Question 2

Does the guidance address the unit of account when software is embedded in a tangible asset (embedded software)?

No. The guidance does not address the unit of account related to embedded software. An entity will need to determine whether the software component is standalone internal-use software that should be accounted for separately under this guidance or embedded software that should be combined with the tangible asset in accordance with other US GAAP, such as ASC 360-10. This determination may be based on the software's operation and functionality.

For example, an entity may develop software that is critical to or enhances the functionality of related property, plant and equipment (PP&E). In this situation, the entity could account for the embedded software as part of the tangible asset (i.e., one unit of account with the related PP&E). However, determining the unit of account may require significant judgment and could be based on other factors. We believe that the approach used by an entity should be applied consistently to similar software development projects.

Question 3**Does the guidance impact ASC 350-50, *Intangibles – Goodwill and Other – Website Development Costs*?**

Yes. The ASU supersedes ASC 350-50 and incorporates the relevant guidance on website-specific development costs into ASC 350-40. Websites were typically used as a means to promote products, replace manual processes or services and sell products when the website development costs guidance was issued. Since then, technology has evolved and websites are now most often used as an interface to access underlying software, the development of which is generally accounted for under ASC 350-40. In practice, most entities view the development of websites and software similarly, and therefore, entities should account for the costs to develop websites and software under the same guidance (ASC 350-40).

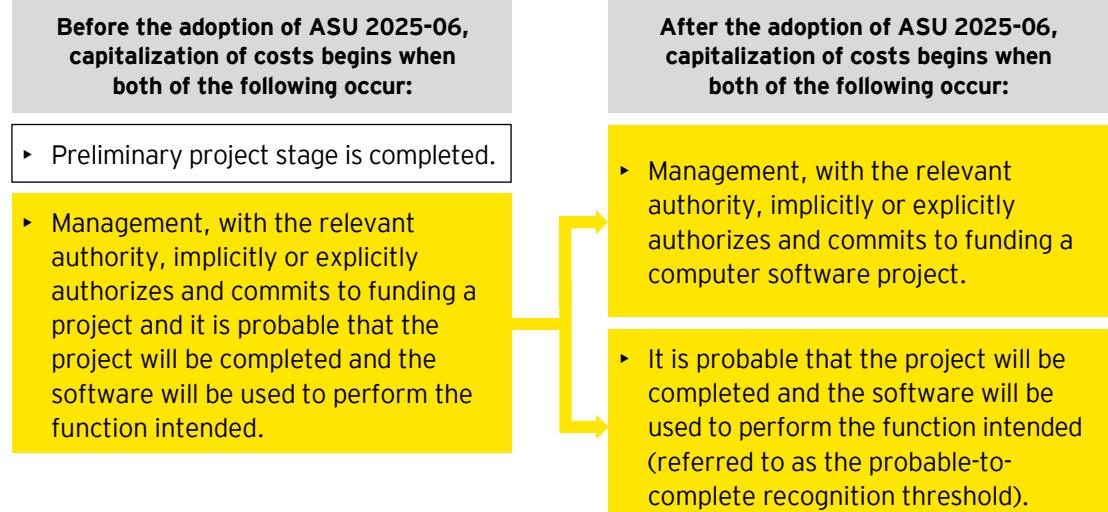
Question 4**Does the guidance impact ASC 730-10, *Research and Development – Overall*?**

No. The ASU does not substantively change the guidance in ASC 730-10 related to research and development (R&D) costs. The following costs of internal-use software are included in R&D and should be expensed as incurred under ASC 730-10:

- ▶ Purchased or leased computer software used in R&D activities where the software does not have alternative future uses
- ▶ All internally developed internal-use software (including software developed by third parties, for example, programmer consultants) if the software (1) is a pilot project or (2) is used in a particular R&D project, regardless of whether the software has alternative future uses

Capitalization threshold

ASC 350-40 requires the capitalization of certain qualified costs incurred in connection with the development, acquisition or modification of an internal-use software project. The ASU changes the criteria to begin capitalizing internal-use software costs (the capitalization threshold). Before the adoption of ASU 2025-06, the internal-use software guidance included three distinct stages of a software project: preliminary project stage, application development stage and postimplementation-operation stage. Understanding each of the three stages and the various activities that take place during these stages was crucial in identifying which costs should be expensed and which costs should be capitalized. The ASU removes all references to project stages throughout ASC 350-40.



Entities need to evaluate whether management, with the relevant authority, has authorized and committed to funding the software project. Examples of authorization and commitment to funding the project include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development or a commitment to obtain the software from a third party.

Additionally, entities need to consider whether the project will be completed and used to perform the function intended. This criterion is referred to in the ASU as the “probable-to-complete recognition threshold.” To improve consistency in application and provide clarity about the probable-to-complete recognition threshold, ASU 2025-06 defines probable as “the future event or events are likely to occur.” It also introduces a new concept of significant development uncertainty to help entities assess the probable-to-complete recognition threshold. Under ASC 350-40-25-12A, the probable-to-complete recognition threshold is not met until significant development uncertainty has been resolved.

Significant development uncertainty exists if either of the following factors is present:

The software being developed has technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to those technological innovations, functions or features, if identified, has not been resolved through coding and testing.

The significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised.

Evaluating whether significant development uncertainty exists may require significant judgment.

The Board made these the only two factors that indicate significant development uncertainty exists. Evaluating whether significant development uncertainty exists may require significant judgment. For some types of software projects, the assessment of whether significant development uncertainty exists may be straightforward (e.g., implementation of an enterprise resource planning system). For other types of software projects, the assessment may be more complex (e.g., creating a new manufacturing optimization software).

How we see it

Entities may need to apply more judgment than they currently do to determine whether and when to capitalize software costs based on the facts and circumstances. However, the Board indicated that it expects entities will capitalize the same or less internal-use software costs after adopting the amendments. In the ASU’s Basis for Conclusions, the Board said that “capitalization of internal-use software costs generally will not change significantly for most types of software under the amendments in this Update. For the development of software to be provided via a cloud computing arrangement (CCA), the Board expects that the amendments could result in a decrease in software capitalization.”⁶ In many cases, this will better align with the financial reporting outcomes for the costs of software sold through an on-premises license.

The software being developed has technological innovations or novel, unique, or unproven functions or features

The first factor that indicates significant development uncertainty exists is whether the software being developed has technological innovations or novel, unique, or unproven functions or features. While the Board did not define these terms, it acknowledged that this language is similar to current guidance for the development of external-use software, specifically when an entity is evaluating whether a detail program design has been reviewed for high-risk development issues.⁷

ASC 985-20 uses novel, unique, unproven functions and features or technological innovations as examples of high-risk development issues. Similar to the external-use software guidance, the ASU also states that uncertainty related to the development of technological innovations or novel, unique, or unproven functions or features should be resolved through coding and testing.



Considerations to assess as part of implementation:

Define technological innovations.

Determine if functions or features are novel, unique or unproven.

Reassess whether functions or features continue to be novel, unique or unproven.

Question 5

Should management assess whether software functions and features are novel or unique from the perspective of the entity or the industry it operates in?

It depends. The guidance does not specify how management should assess whether software functions and features are novel or unique. Management will need to apply judgment to make this assessment. This could include considerations from the entity's own perspective, in addition to considerations of widely recognized technological innovations that are readily accessible to the entity.

Question 6

Does the ASU include any considerations for artificial intelligence (AI)?

No, the guidance does not provide specific guidance for AI software development. Entities will need to understand the nature of costs incurred to develop AI to determine the appropriate accounting guidance to apply (e.g., internal-use software cost guidance, external-use software cost guidance, intangible assets guidance, R&D costs guidance).

For AI development costs determined to be in the scope of ASC 350-40, the evaluation of whether such costs are eligible for capitalization should be consistent with the evaluation of other internal-use software costs. That is, entities should evaluate the capitalization threshold, including whether significant development uncertainty exists (e.g., whether the AI being developed is novel). This may require a careful assessment based on the facts and circumstances of each AI development project.

The significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised

The second factor that indicates significant development uncertainty exists is whether the significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised. The guidance defines performance requirements as "what an entity needs the software to do (for example, functions or features)." This definition aligns with how performance requirements are described in the preliminary project stage. While the Board indicated that the term "significant" is widely used in US GAAP and well understood in practice, we believe evaluating significance will be an area of judgment and will depend on an entity's facts and circumstances.



Considerations to assess as part of implementation:

Identify which performance requirements are deemed significant.

Assess when performance requirements continue to be substantially revised.

Determine which changes to performance requirements are considered to be substantial.

Based on the capitalization criteria outlined above, there are no bright lines for determining whether software project costs should be capitalized or expensed. The Board acknowledged that applying the amendments requires judgment to determine whether and when an entity capitalizes software costs based on the entity's evaluation of its facts and circumstances.⁸

Question 7

Does the ASU address considerations specific for an agile development method?

No. The guidance does not directly address any specific development methods and requires the same recognition threshold for all internal-use software, regardless of the development method. However, the significant development uncertainty factors, particularly the factor related to significant performance requirements, are aligned with the agile development method where the development process is iterative and often times has frequent updates to performance requirements. Entities will need to carefully assess their facts and circumstances to determine the significant performance requirements and whether they are subject to significant revisions.

Question 8

With the level of judgment required to evaluate significant development uncertainty, will the guidance require information technology (IT) specialists to be involved?

No, the Board does not expect the application of the amendments will require entities to use IT experts.⁹ As such, we do not believe that engaging IT experts to evaluate whether significant development uncertainty exists would be required. However, we believe that strong communication between the IT and finance departments is essential to make sure that requirements are appropriately supported and well-documented. Entities will need to carefully consider and evaluate their positions and conclusions related to the capitalization criteria.

The following example illustrates how an entity would determine when to begin capitalizing internal-use software with novel technology.

Illustration 1 – Development of a novel technology from ASC 350-40-55-13 through 55-17

Assume that on 1 January 20X1, a software development company starts discussions to develop software with novel functionality. On 1 February 20X1, management completes its due diligence procedures, approves a budget to internally develop the software and allocates an internal development team to start developing the novel software. At the time that the company started discussions and management approved a budget, the software still had novel functionality.

On 1 March 20X3, the company resolves the uncertainty related to the novel functionality through coding and testing. Additionally, the company determines that it does not expect substantial changes to the identified significant performance requirements (the significant functions and features) included in the software. On 1 April 20X3, the company determines that all substantial testing is completed (i.e., the software project is substantially complete and ready for its intended use).

The company assesses whether the costs to develop the software meet the capitalization requirements in paragraphs 350-40-25-12 through 25-12A.

The company evaluates the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing software costs. The company determines that management authorized and committed to funding the software project on 1 February 20X1, when it approved a budget and allocated an internal development team, thus the first capitalization criteria is met.

The company then considers if the probable-to-complete recognition threshold has been met and evaluates whether there is significant development uncertainty in accordance with paragraph 350-40-25-12A. As of 1 February 20X1, the company determines that:

1. It has not identified the significant performance requirements.
2. The software being developed has novel functionality and that functionality has not been resolved through coding and testing.

Therefore, as of 1 February 20X1, the company determines that significant development uncertainty exists in accordance with paragraph 350-40-25-12A, and the probable-to-complete recognition threshold has not been met. Therefore, the software project does not meet the requirements to begin capitalizing software costs.

As of 1 March 20X3, the company determines that:

1. It has identified the significant performance requirements and does not expect to continue to substantially revise those requirements.
2. The uncertainty related to the novel functionality has been resolved through coding and testing.

Therefore, as of 1 March, 20X3, the company determines that significant development uncertainty has been resolved.

Considering all other relevant facts and circumstances, as of 1 March 20X3, the company determines it is probable that the software project will be completed and the software will be used to perform the function as intended. The probable-to-complete recognition threshold is now met and capitalization of costs should begin.

The ASU does not change the nature of the costs that are capitalizable.

Capitalizable costs

Internal and external costs incurred before meeting the capitalization requirements discussed above should be expensed as they are incurred. Once significant development uncertainty (if any) has been resolved, an entity would begin capitalizing certain software costs if all the other capitalization requirements have been met.

The ASU does not change the nature of the costs that are capitalizable. Consistent with the current guidance, costs of computer software developed or obtained for internal use that should be capitalized after all capitalization requirements are met include only the following:

- ▶ External direct costs of materials and services consumed in developing or obtaining internal-use computer software. These costs include, among others, fees paid to develop software, costs to purchase software from third parties and travel expenses incurred by employees in their duties directly associated with developing software.
- ▶ Payroll and payroll-related costs (e.g., benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project (e.g., designing, coding, testing, installing hardware).
- ▶ Costs to develop or obtain software that allows for access to or conversion of old data by new systems
- ▶ Interest costs incurred while developing internal-use computer software (capitalized in accordance with ASC 835-20, *Interest – Capitalization of Interest*)
- ▶ Costs for upgrades and enhancements only if it is probable they will result in additional functionality

Certain types of costs are not capitalizable and should be expensed. These include but are not limited to:

- ▶ Internal and external training costs (including costs to train employees to develop, configure or implement software)
- ▶ Overhead costs, including general and administrative costs
- ▶ Data conversion costs
- ▶ Maintenance activities, or modifications that extend the useful life without adding new capabilities or functionality

Upgrades and enhancements are modifications to existing software that result in additional functionality (i.e., modifications to enable the software to perform tasks that it previously was not capable of performing). Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred. For upgrades and enhancements, entities need to apply the same capitalization criteria as a new software project, including determining whether significant development uncertainty exists.

Capitalization of costs stops when the software project is substantially complete and ready for its intended use, which is after all substantial testing is completed.

Subsequent measurement

The ASU does not change the subsequent measurement of internal-use software costs. The amortization and impairment considerations are the same as the current guidance.

Amortization

Capitalized costs of internal-use software are amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use. Amortization should begin for each component or module when the software is ready for its intended use. When assigning useful lives to internal-use software, entities consider the effects of obsolescence, competition, technology and other economic factors.

Software often has a relatively short useful life due to the nature of the rapid changes occurring in the development of software products, operating systems and computer hardware. Entities need to reassess the useful life of capitalized internal-use software when facts and circumstances change (e.g., the software will be replaced).

Impairment considerations

If the capitalization requirements are no longer met for software being developed, no further costs should be capitalized. When it is no longer probable that computer software being developed will be completed or placed in service, the software is reported at the lower of its carrying amount or fair value less costs to sell. Under ASC 350-40-35-3, there is a rebuttable presumption that software has a fair value of zero if there are no plans to complete the software.

Capitalized internal-use software costs are evaluated for impairment in accordance with the *Impairment or Disposal of Long-Lived Assets* subsection of ASC 360-10-35, which requires that assets be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. In many cases, internal-use software is included in a higher-level asset grouping (e.g., the entity level).

ASC 350-40-35 includes the following examples of indicators that internal-use software has been impaired:

- ▶ The software is not expected to provide substantive service potential.
- ▶ A change occurs in the extent or manner in which the software is used or expected to be used.
- ▶ A significant change to the software is made or expected to be made.
- ▶ Cost to develop or modify internal-use software significantly exceeds the amount originally expected to be incurred (cost overruns) to develop or modify the software.

The above list of impairment indicators is not intended to be all inclusive. Additional impairment indicators could exist depending on an entity's business environment.

If there is an impairment indicator associated with capitalized internal-use software that is included in a higher-level asset grouping, an entity should consider the significance of that individual asset to the asset group as a whole to determine whether an impairment test at the asset group level is needed. Additionally, an entity may need to reassess the estimated remaining useful life associated with capitalized internal-use software. For example, management could decide that the software will be replaced earlier than planned and, rather than recognizing an impairment loss (i.e., the asset group tested, including the software, is recoverable), the expected remaining life is revised and amortization adjusted prospectively (i.e., a change in estimate).

When an entity replaces existing software with new software, unamortized costs of the old software are expensed when the new software is ready for its intended use.

Presentation and disclosure

Presentation

The ASU does not include any incremental presentation requirements for capitalized internal-use software. However, there are presentation requirements in the existing guidance specific to implementation costs of a cloud computing arrangement that is a service contract (i.e., when an entity (the customer) enters into a cloud computing arrangement).

Internal-use software, except a cloud computing arrangement that is a service contract

Generally, capitalized internal-use software costs are presented in PP&E or intangible assets on the balance sheet. The guidance under ASC 350-40-25-17 requires the classification of purchased software costs (including a software license) as an intangible asset if it is a project within the scope of internal-use software guidance. If all or a portion of the software licensing fees are not paid on or before the acquisition date of the license, a liability is recorded by the licensee.

The amortization of capitalized internal-use software costs is generally included in depreciation and amortization on the income statement. While there is no guidance on how capitalized internal-use software costs should be classified in the statement of cash flows, those costs are generally classified as investing cash flows.

A cloud computing arrangement that is a service contract (the entity is a customer)

Entities will recognize implementation costs incurred in cloud computing arrangements the same way that they recognize implementation costs incurred in internal-use software projects. However, the financial statement presentation is not the same.

Capitalized implementation costs related to cloud computing service contracts should be presented in the same line item in the balance sheet that a prepayment of the fees for the associated cloud computing arrangement would be presented.

The amortization of capitalized implementation costs related to cloud computing service contracts should be presented in the same line item in the income statement as the fees associated with the hosting element of the arrangement.

Payment for capitalized implementation costs should be classified in the statement of cash flows in the same manner as payments of the fees for the service component of the cloud computing arrangement. While there is no guidance on how hosting service fees should be classified on the statement of cash flows, we believe that payments for hosting fees and capitalized implementation costs generally should be classified as operating cash flows.

The following table outlines the differences in the financial statement presentation of internal-use software compared to a customer's cloud computing arrangement that is a service contract.

Financial statement	Internal-use software*	Cloud computing arrangement that is a service contract
Balance sheet	Capitalized software costs are generally presented in PP&E or as intangible assets	Capitalized implementation costs are required to be recognized in the same line item that a prepayment of the cloud computing arrangement would be presented
Income statement	Amortization of capitalized software costs are generally included in depreciation and amortization as an operating expense	Amortization of capitalized implementation costs are required to be recognized in the same line item as the expense for hosting fees
Statement of cash flows	Cash flows for capitalized software costs are generally classified as investing activities	Cash flows for capitalized implementation costs should be classified in the same manner as hosting fees (generally operating activities)

* Except for a cloud computing arrangement that is a service contract.

Disclosure

ASU 2025-06 clarifies that the PP&E disclosure requirements under ASC 360-10 apply to all capitalized software costs accounted for under ASC 350-40, regardless of how they are presented in the financial statements.

For example, entities will need to disclose the capitalized internal-use software balance and accumulated amortization at the balance sheet date, the amortization for the period and a general description of the method used in computing amortization. The Board noted that these disclosures would give investors more consistent information about an entity's internal-use software costs.¹⁰

The ASU does not change the current requirements under ASC 350-40 to disclose the nature of their cloud computing arrangements that are service contracts and make the disclosures in ASC 360-10 as if the capitalized implementation costs were a separate major class of depreciable asset.

How we see it

Entities will need to evaluate whether their historical disclosures are sufficient and provide the necessary information. Depending on the presentation of capitalized software costs within the balance sheet and income statement, entities may need to revise their disclosures to make sure they meet the requirements in the guidance.

The guidance states that the disclosure requirements in ASC 275, *Risks and Uncertainties*, ASC 730-10 and ASC 235, *Notes to Financial Statements*, should also be considered. It also clarifies that the disclosures under the intangible assets guidance in ASC 350-30-50-1 through 50-3 are not required for software costs capitalized under ASC 350-40.

Other considerations

Internal control over financial reporting

Entities should evaluate whether changes to their existing processes and internal controls are necessary. This evaluation should consider the design of the controls over the assessment of the probable-to-complete recognition threshold, particularly the two factors indicating that significant development uncertainty exists.

Management's judgment and related considerations should be documented in line with the guidance to support the conclusions reached. Strong integration between IT, finance and other relevant departments is essential to apply the requirements of the new guidance and make sure appropriate evidence related to judgments applied by management is retained.

How we see it

Entities should assess their internal control over financial reporting to determine whether updates are needed to reflect the new guidance, particularly related to evaluation of whether significant development uncertainty exists. Documentation supporting management's judgments and conclusions reached on when the capitalization criteria are met will be important.

Effective date and transition

The guidance is effective for all entities for fiscal years beginning after 15 December 2027, and interim periods within those fiscal years. An entity that adopts the guidance in an interim period will do so as of the beginning of the fiscal year that includes that interim period. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

Upon adoption of the guidance in both the interim period (if applicable) and the annual reporting period of the change, entities are required to disclose the nature of and reason for the change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections*.

Entities may apply the guidance using a prospective, retrospective or modified transition approach. Under the prospective approach, entities apply the guidance to new software costs incurred for all projects, including costs incurred for in-process projects, as of the beginning of the period of adoption.

Under the modified transition approach, entities apply the guidance on a prospective basis to new software costs incurred (for all projects, including costs incurred for in-process projects), except for in-process projects that do not meet the new capitalization requirements but had met the capitalization requirements before adoption of the amended guidance. Entities are required to derecognize any capitalized costs for these in-process projects through a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the annual reporting period of the date of adoption.

Under the retrospective approach, entities apply the guidance as of the beginning of the first period presented and disclose (1) the method used to apply the change, (2) the cumulative effect of the change on retained earnings or other components of equity in the statement of financial position and (3) the effect of the change on income from continuing operations, net income (or other appropriate line items of changes in the applicable net assets or performance indicator), any other affected financial statement line item and affected per-share amounts for prior periods retrospectively adjusted.

Next steps

When implementing the new guidance, an entity should:

- ▶ Assess whether updates need to be made to its policy to evaluate the amended capitalization criteria
- ▶ Assess the judgments required to evaluate the factors that indicate significant development uncertainty exists
- ▶ Strengthen cross-functional communication between the IT, finance and other relevant departments
- ▶ Evaluate whether changes to processes, internal controls and data capture are necessary
- ▶ Establish robust documentation to support judgments and conclusions
- ▶ Evaluate whether changes to disclosures of capitalized software costs are necessary
- ▶ Determine which transition approach will be used and reassess in-progress projects, if applicable
- ▶ Consider whether to elect early adoption

Endnotes:

- ¹ ASU 2025-06, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*.
- ² Paragraph BC4 of the ASU's Background Information and Basis for Conclusions.
- ³ The term hosting arrangement is defined in the Master Glossary of the Codification as "... an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis." Hosting arrangement, cloud computing arrangement and software as a service (SaaS) are often used interchangeably to describe these types of arrangements.
- ⁴ Paragraph BC61.
- ⁵ Paragraph BC63.
- ⁶ Paragraph BC4.
- ⁷ Paragraph BC46.
- ⁸ Paragraph BC32.
- ⁹ Paragraph BC32.
- ¹⁰ Paragraph BC94.