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To the Point

FASB – final guidance

FASB modernizes guidance on accounting for internal-use software

The FASB issued final guidance to clarify and modernize the accounting for costs related to internal-use software.

What you need to know

- The FASB issued final guidance to clarify and modernize the accounting for costs related to internal-use software.
- The guidance removes all references to project stages in ASC 350-40 and clarifies the threshold entities apply to begin capitalizing costs.
- 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) issued a final Accounting Standards Update (ASU)[1] that clarifies and modernizes the accounting for costs related to internal-use software in Accounting Standards Codification (ASC) 350-40, *Intangibles – Goodwill and Other – Internal-Use Software*. The guidance removes all references to project stages throughout ASC 350-40 and clarifies the threshold entities apply to begin capitalizing costs. The ASU is intended to address stakeholder feedback that the current guidance for software costs is outdated and not relevant given the evolution of software development.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 has resulted in challenges when applying the current guidance, including determining when to begin capitalizing internal-use software costs.

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

Key considerations

The new guidance removes all references to project stages throughout ASC 350-40. The Board believes this change increases the operability of applying the internal-use software guidance to software costs incurred in an iterative development environment. In addition, the guidance is now neutral to different software development methods and is less likely to become outdated over time.[2]

With the removal of all references to project stages, the new guidance requires entities to begin capitalizing software costs when both of the following occur:

- Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project.
- It is probable that the project will be completed and the software will be used to perform the function intended (referred to as the probable-to-complete recognition threshold).

To improve consistency in application and provide clarity about the probable-to-complete threshold, the ASU defines probable as "the future event or events are likely to occur." The probable-to-complete recognition threshold is not met until significant uncertainty associated with the development activities of the software (referred to as 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.

The ASU defines performance requirements as "what an entity needs the software to do (for example, functions or features)." This definition is consistent with how performance requirements is described in the existing definition of the preliminary project stage.

Once the significant development uncertainty has been resolved, an entity would begin capitalizing software costs if all the other capitalization requirements have been met. The ASU includes examples illustrating how an entity would apply the capitalization criteria and evaluate whether there is significant development uncertainty.

In the ASU's Background Information and Basis for Conclusions, the Board said "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."[3]

How we see it

Under the new guidance, 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. For example, to evaluate whether significant development uncertainty exists, an entity will need to determine whether the software being developed has functions or features that are novel, unique or unproven. If it doesn't, the entity will need to identify the software's performance requirements, determine which performance requirements are significant and understand whether the identified significant performance requirements will continue to be substantially revised.

Other amendments

The new guidance supersedes ASC 350-50, *Intangibles — Goodwill and Other — Website Development Costs*, and incorporates the relevant guidance on website-specific development costs into ASC 350-40.

Disclosure requirements

Entities need to disclose all software costs capitalized under ASC 350-40 in accordance with ASC 360-10.

The guidance specifies that the property, plant and equipment disclosure requirements under ASC 360-10 apply to all capitalized software costs accounted for under ASC 350-40, regardless of how the costs 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.[4]

The guidance 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.

Internal control considerations

Entities should evaluate whether changes to their existing processes and internal controls are necessary. They will need to 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.

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. Entities may apply the guidance using a prospective, retrospective or modified transition approach.

Entities that choose the prospective transition approach would 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.

Entities that elect a modified transition approach need to 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 date of adoption.

Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance. 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.

Endnotes:

[1] Accounting Standards Update (ASU) 2025-06, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Accounting for and Disclosure of Software Costs*.

[2] Paragraph BC23(a) of the ASU's Background Information and Basis for Conclusions.

[3] Paragraph BC4.

[4] Paragraph BC94.