

# Business Guidance Note

## Guidance Note 10

As part of the Institute's ongoing efforts to provide members with guidance and information on key issues, the Institute has developed a Business Guidance Notes series which presents guidance for members written by members.

The Australian Accounting Standards that provide guidance when considering software capitalisation policy are:

- > AASB138 – *Intangible Assets*
- > AASB116 – *Property Plant & Equipment*
- > AASB136 – *Impairment of Assets*

### Key points

- > Levels of approval should be determined in the policy
- > The cut off for capitalisation will vary by company
- > The company should adopt a project charging mentality – move expense from business as usual to project
- > The rolling effect of capitalisation / amortisation – over time should balance out to underlying annual level of investment required by the company
- > Maintenance costs should be included in the budget going forward.

This Business Guidance Note is an initiative of the Institute's NSW Corporate Advisory Panel and has been prepared by the following contributors.

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## Software Capitalisation

This guidance note looks at the key points to consider when developing a software capitalisation policy. Policy specifics will vary depending on the size of the organisation and type of software development activity undertaken.

Software capitalisation occurs when some of the costs of internal software developments are recognised as having economic value that will extend into the future (i.e. will have future economic benefit). Where certain criteria are met, the cost of software development can be taken up as an asset to be amortised over its useful life.

### Impairment testing

At the end of each reporting period, the net carrying value of unamortised software costs is subject to trigger testing. If the triggers are present, an impairment test is performed. Impairment testing is a review of the value to be produced by the software during its remaining useful life in order to confirm existence of any impairment (which would lead to the write down of the carrying value).

Australian Accounting Standards specify that an intangible asset shall be recognised if, and only if:

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity
- The cost of the asset can be measured reliably.<sup>1</sup>

Consideration should be given to the design of the impairment trigger testing that will be applied. This should be sought to leverage existing reporting mechanisms wherever possible, which may include a robust project status reporting mechanism.

### Application of software capitalisation

Application of software capitalisation often depends on the judgement of the individual and organisation applying it, and will vary depending on the policies of each company. For example, internal limits may be set so projects with budgets below the limit are expensed, with such limits often aligned with financial delegations and governance structures. For practical purposes small developments are often regarded as part of infrastructure maintenance that is necessary for the ongoing effective operation of systems, and are expensed as incurred. Any immaterial software items are usually expensed immediately.

The overarching principle is that software capitalisation is subject to criteria within the Accounting Standards, the interpretation of which will guide internal policy. The Accounting Standards specify which costs of an internally generated intangible asset can be capitalised. There are examples included of what are normally considered components of the intangible asset.<sup>2</sup>

### Governance

Strong governance is critical to retain integrity in financial reporting, including systems for tracking of costs and benefits. Decisions must be made in determining what can be capitalised, the time period for amortisation, (the longer the useful life the higher the risk of impairment given the rapid development of software), and the process and value for impairment purposes.

1. AASB 138 – paragraph 21  
2. AASB 138 – paragraph 65-67

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### Important items to consider:

- > Timeliness of capture – recording detail on an ongoing basis is very important
- > The approach to capturing expenses for capitalisation – consider the process to identify expenses at the first processing of costs, rather than after the event
- > The importance of having ledger systems set up to record expenses by project – this will make data easy to extract
- > The coding of the account – this will ensure Project Accounting and Expense reporting needs are met
- > The capitalisation of backfill staff – business as usual staff are seconded to development
- > The timing of the project's start – measuring the total project costs is different to the amount capitalised
- > The interrelationship with tax effects – deferred tax impact
- > Any opportunities for Research and Development (R&D) grants
- > The tax treatment of software vs. accounting treatment
- > Whether the project meets requirement for additional tax R&D benefits.

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There will usually be differing views as to how those decisions should be applied. This may arise when considering whether judgement should be exercised to maximise the costs capitalised and so defer expenses (subject to impairment), or to minimise the costs capitalised, thereby minimising the risk of impairment. This highlights the importance of a clear software capitalisation policy.

When there is a group corporate structure in place and there are recharges between companies comprising the development costs, care must be taken to ensure that any profit margins built in are not capitalised, as these are not part of the costs to the group.

Broadly, only costs related to the development stage are able to be capitalised.

The following table illustrates some examples of research and development costs:

Research Phase	Development Phase
<b>Expense</b>	<b>Capitalise</b>
Activities aimed at obtaining new knowledge	The design, construction and testing of pre-production/pre-use prototypes and models
The search for, evaluation and final selection of, applications of research findings	The design of tools/framework involved in the new technology
The search for alternatives for materials, devices, products, processes, systems or services	The design, construction and operation of a pilot that is not of a scale economically feasible for commercial production
The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services	The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

In breaking out the responsibilities in relation to software capitalisation, the following table provides a suggested split:

Finance Team	Finance Policy
Gathering data supporting proposed accounting treatment	Setting the accounting policy and organisations thresholds for software capitalisation
Developing a detailed understanding of the project to support both capital investment and accounting treatment	Supporting the accounting policy as it requires it
Assessing software capitalisation requirements and preparing submission on accounting treatment	Approving individual software capitalisation project applications
Ongoing monitoring of development costs to confirm satisfaction of capitalisation requirements	Obtaining Audit Committee approval and reporting
Conducting annual testing for impairment assessment	Providing an overview of the impairment process

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