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**University of California
GASB 35 Depreciation Reporting**

Issues Resolution Memo No. 11

(Re-issued March 31, 2003)

Approach to Software

Define Issues

The University must establish guidelines for the consistent treatment and reporting of the costs of computer software developed internally or obtained from a third party for internal use (campus and medical centers).

Background

During 1999, the Government Accounting Standards Board (GASB) introduced GASB Statements 34 and 35. Among other matters, these Statements will require the University to account for depreciation in its financial statements for the fiscal year beginning July 1, 2001, with comparative information for the prior year. Financial statements must be prepared in accordance with Generally Accepted Accounting Principles (GAAP) and are subject to audit under Generally Accepted Auditing Standards (GAAS).

AICPA Statement of Position

The Accounting Standards Division of the American Institute of Certified Public Accountants (AICPA) issued a Statement of Position (SOP) on March 4, 1998, that provides guidance on accounting for the costs of computer software developed or obtained for internal use (i.e., not to be sold or otherwise marketed). It should be noted that the SOP technically does not apply to public institutions such as the University; however, the principles and issues are the same for public institutions. The SOP should enter into the consideration of the quality of the University's accounting policies.

SOP Summary

- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining

internal-use computer software; payroll and payroll-related costs 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); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and data conversion costs...should be expensed as incurred.

- Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20 – .23. Internal costs incurred for maintenance should be expensed as incurred. 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.
- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20 – .23. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software’s use.

Paragraph .12—For purposes of this SOP, internal-use software is software having the following characteristics:

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

Paragraph .17—The following table illustrates the various stages and related processes of computer software development.

Preliminary Project Stage	Application Development Stage	Post-Implementation/Operation Stage
Conceptual formulation of alternatives	Design of chosen path, including software configuration and software interfaces	Training
Evaluation of alternatives	Coding	Application maintenance
Determination of existence of needed technology	Installation to hardware	
Final selection of alternatives	Testing, including parallel processing phase	

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

Paragraph .19 Preliminary Project Stage—When a computer software project is in the preliminary project stage, entities will likely—

- a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?
- b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
- c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.
- d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?
- e. Determine that the technology needed to achieve performance requirements exists.
- f. Select a vendor if an entity chooses to obtain software.
- g. Select a consultant to assist in the development or installation of the software.

Paragraph .20—Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

Paragraph .21 Application Development Stage—Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

Paragraph .22—The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

Paragraph .23 Post-Implementation/Operation Stage—Internal and external training costs and maintenance costs should be expensed as incurred.

Recommended Approach

The AICPA SOP was considered in developing the University's approach to computer software costs.

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 \$1,500 per copy. As such, consolidated software purchases will not be capitalized where the cost per copy is less than \$1,500 per copy, even though the total cost is greater than \$1,500.
- Campuses may create an object code to record purchased software expenses that are less than \$1,500. 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 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 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.

Example—

- At June 30, 2002, campuses will capitalize purchased software expenditures that are greater than \$1,500 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 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.

<i>Example 1</i>	<u><i>Total Project Costs</i></u>	<u><i>\$8 million</i></u>
	<i>External Software</i>	<i>\$5 million</i>
	<i>External Consultant</i>	<i>\$3 million</i>
	<i>Internal Development</i>	<i>\$0</i>

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 threshold.

▪ <i>Example 2</i>	<u><i>Total Project Costs</i></u>	<i>\$9 million</i>
	<i>External Software</i>	<i>\$5 million</i>
	<i>External Consultant</i>	<i>\$3 million</i>
	<i>Internal Development</i>	<i>\$1 million</i>

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.

▪ <i>Example 3</i>	<u><i>Total Project Costs</i></u>	<i>\$12 million</i>
	<i>External Software</i>	<i>\$5 million</i>
	<i>External Consultant</i>	<i>\$3 million</i>
	<i>Internal Development</i>	<i>\$4 million</i>

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.

Next Steps—Required Actions

- OP will seek concurrence with the recommended approach at the November North/South campus meetings at UC Irvine.