FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Accounting for and Disclosure of Intangibles—Software Costs

April 13, 2022

Meeting Purpose

1. The purpose of the April 13, 2022 Board meeting is the provide the Board with information on the accounting for software costs and a summary of research that the staff has performed to date, including feedback received on this area in connection with the June 2021 Invitation to Comment, *Agenda Consultation* (2021 ITC). This discussion is intended to help the Board prepare for an agenda decision meeting expected to be held in the second quarter of 2022 during which the Board would decide whether to add a project on the accounting for and disclosure of software costs to its technical agenda. The April 13, 2022 Board meeting will only cover the accounting for software costs and not the broader accounting for and disclosure of intangibles research project, which will be addressed with the Board separately at a future meeting.

2. At the April 13, 2022 Board meeting, because there are a wide variety of potential project scopes and objectives that could be pursued to address this area of generally accepted accounting principles (GAAP), the staff will ask the Board directional questions to help focus the staff's pre-agenda research and analysis for a forthcoming agenda decision. In addition, the staff will ask the Board for feedback on what additional information it needs to make a future agenda decision on this project, beyond the staff research plan outlined at this Board meeting.

Questions for the Board
1. If the Board was to add a project to the technical agenda on the accounting and disclosure of software costs, do you prefer that the potential project scope include both internal-use software and external-use software? If not, what would you prefer the project scope to be?
2. If the Board was to add a project to the technical agenda for the accounting and disclosure of software costs, does the Board have any feedback on the potential project objective(s)?
3. If the Board was to add a project to the technical agenda for the accounting and disclosure of software costs, are there any potential solutions that you would prefer (a) further exploring or (b) not further exploring?

4. Beyond the staff research plan outlined at the April 13, 2022 Board meeting, what additional information do you need before making an agenda decision about whether to add a project to the technical agenda?

Research Project Background

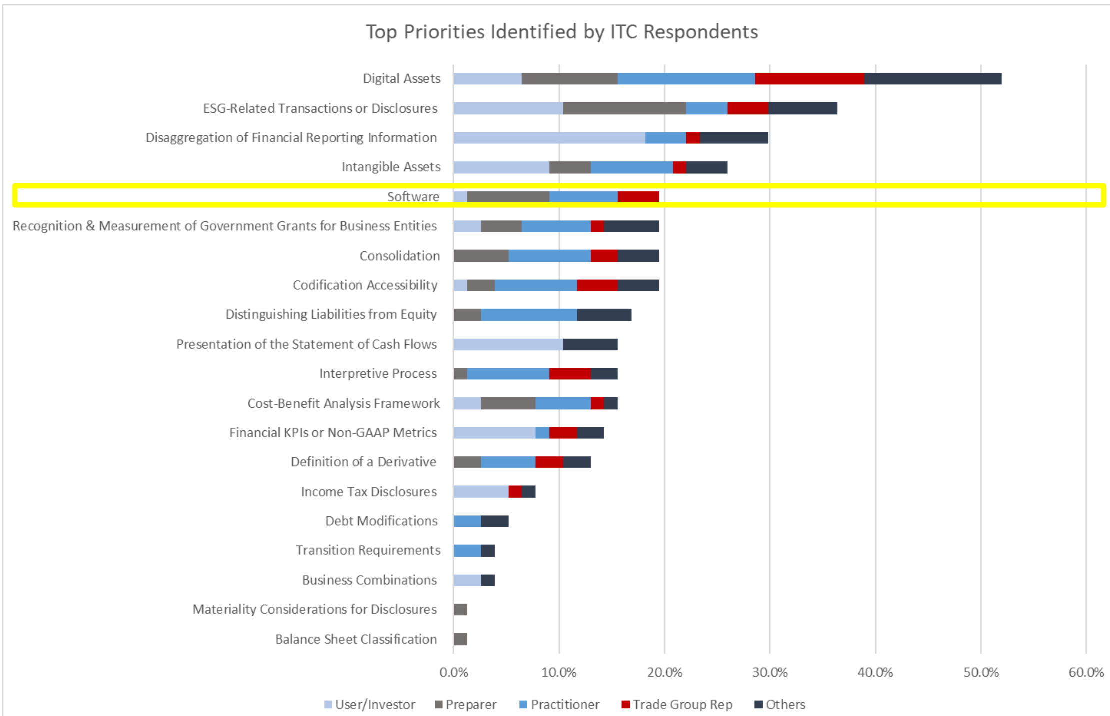
3. In June 2021, the staff issued the 2021 ITC to solicit broad stakeholder feedback on the future standard-setting agenda of the FASB. On the basis of significant input received from stakeholders during the first half of 2021, the following discussion on the accounting for software costs was included in the 2021 ITC:

> Stakeholders provided feedback that the technological feasibility capitalization threshold in Subtopic 985-20, Software—Costs of Software to Be Sold, Leased, or Marketed, requires a significant amount of judgment and ultimately results in very little capitalization of software costs, especially considering the evolution of the software market. Similarly, stakeholders expressed concerns about the guidance on capitalizing costs incurred to develop internal-use software in Subtopic 350-40, Intangibles—Goodwill and Other—Internal-Use Software. Stakeholders urged the Board to consider whether the software capitalization models in Subtopics 350-40 and 985-20 continue to be relevant and to reevaluate the costs and benefits of applying the guidance. Suggested solutions from stakeholders ranged from changing the capitalization thresholds so that companies can capitalize more software costs to allowing companies an option to expense all software costs as incurred. Stakeholders suggested that the guidance for software capitalization costs should be consistent regardless of whether the software is internally used or to be sold, leased, or otherwise marketed.

4. Furthermore, Question 19 of the 2021 ITC specifically asked respondents:

> What challenges, if any, exist in applying the capitalization thresholds in Subtopics 350-40 and 985-20? What improvements, if any, could be made to the software capitalization guidance to overcome those challenges? Should there continue to be a capitalization threshold when accounting for software depending on whether it is for internal use or whether it is to be sold, leased, or otherwise marketed? Please explain.

5. Over one-third of respondents across all stakeholder types provided feedback on accounting for software, and approximately half of those respondents identified accounting for software as a top priority. There were no respondents that indicated that they would not support the Board addressing this area. To provide perspective on how respondents to the 2021 ITC identified the software as a priority, the staff has excerpted the following chart from the Feedback Summary on the 2021 ITC, which provides a visual representation of the areas that respondents identified as top priority, in order of most frequently identified to least frequently identified:



6. In response to feedback received on the 2021 ITC, the FASB Chair added accounting for and disclosure of software costs as part of the accounting for and disclosure of intangibles research project at the December 15, 2021 Board meeting.

U.S. Accounting Requirements

7. There are two main areas of GAAP that provide accounting guidance for software costs—Subtopic 985-20, Software—Costs of Software to Be Sold, Leased, or Marketed, and Subtopic 350-40, Intangibles—Goodwill and Other—Internal-Use Software. To determine the accounting for software costs, a company first must evaluate what area of GAAP applies; the guidance that a company must follow is largely dependent on how a company plans to use the software. When a company determines that it has a substantive plan to sell, lease, or otherwise market the software externally, such as by licensing on-premises software, it is required to

account for the software costs as external use and apply Subtopic 985-20. Conversely, when a company does not have such a substantive plan in place when the software is under development and is developing or has purchased software for internal purposes only, such as by developing an internal payroll system, it is required to account for the software costs to develop or purchase software as internal use under Subtopic 350-40. Furthermore, the guidance in Subtopic 350-40 for internal-use software is generally applied to hosting arrangements, by both the vendor that is incurring costs to develop the hosting arrangement (such as software as a service [SaaS] that is not going to be licensed to the customer) to provide to customers and customers incurring costs to implement hosting arrangements.

Subtopic 985-20—Costs of Software to Be Sold, Leased, or Marketed

8. Subtopic 985-20 provides guidance on the accounting for software development costs incurred for software that will be sold, leased, or otherwise marketed as a separate product or as part of a product or process (referred to as external-use software or externally marketed software). That guidance was established by FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, which was issued in August 1985 and has largely remained unchanged since then.

9. Paragraph 985-20-15-3 specifies that Subtopic 985-20 does not apply to the following transactions or activities:

   (a) Software developed or obtained for internal use

   (b) Research and development (R&D) assets acquired in a business combination or an acquisition by a not-for-profit entity

   (c) Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization.

10. Subtopic 985-20 requires that all development costs to establish the technological feasibility of external-use software are R&D costs that should be expensed as incurred in accordance with Subtopic 730-10, Research and Development—Overall. Entities are required to capitalize development costs incurred after establishing technological feasibility (often referred to as production costs) until the product is available for general release. Technological feasibility is established when the company has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements.

11. Software may be sold as a part of a hosting arrangement, such as SaaS that will be accessed via an online portal. For vendors—entities that are providing SaaS solutions to customers—those types of software arrangements fall within the scope of Subtopic 985-20 if both of the following criteria are met:

(a) The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

(b) It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

12. Paragraph 985-20-15-6 states that in determining whether the customer has the contractual right to take possession of the software without significant penalty, entities must evaluate whether customers can take delivery of software without incurring significant cost and use the software separately without significant decline in value or utility. In the case that the criteria in paragraph 11 are not met, entities (vendors) are required to account for software costs under Subtopic 350-40 as internal-use software.

Subtopic 350-40—Costs of Software Developed or Obtained for Internal Use

13. Subtopic 350-40 provides guidance on how to account for the costs a company incurs (a) to develop internal-use software, (b) to acquire internal-use software, and (c) to implement a hosting arrangement that is a service contract (often referred to as a cloud computing arrangement or CCA). Subtopic 350-40 is largely based on the American Institute of Certified Public Accountants' (AICPA) Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, which was issued to provide guidance on internal-use software. At the time SOP 98-1 was issued, there was diversity in practice.

14. Subtopic 350-40 explains that internal-use software has both of the following characteristics:

(a) The software is acquired, internally developed, or modified solely to meet an 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.

15. Under Subtopic 350-40, certain costs incurred for computer software developed or obtained for internal use should be capitalized depending on the nature of the costs and the project stage during which they occur. Subtopic 350-40 describes the following three stages of software development and implementation activities:

(a) **Preliminary project stage**—The Master Glossary of the *FASB Accounting Standards Codification*® describes a list of activities that entities typically undertake during this stage. Additionally, paragraph 350-40-55-3(a) lists related processes associated with this stage, including the conceptual formulation of alternatives, evaluation of alternatives, determination of existence of needed technology, and final selection of alternatives. Paragraph 350-40-25-1 requires that all activities performed during the preliminary project stage of development be expensed as incurred.

(b) **Application development stage**—Paragraph 350-40-25-2 requires a company to capitalize costs incurred to develop internal-use computer software during the application development stage. Paragraph 350-40-25-12 states that capitalization of costs should begin (i) when the preliminary project stage is complete and (ii) when management authorizes and commits funding to a software project that is probable to be completed and the software will be used to perform the function intended. Paragraph 350-40-25-14 states that capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. Paragraph 350-40-25-14 also establishes that software is ready for its intended use when all substantial testing is completed, and paragraph 350-40-55-3(b) highlights typical activities that take place during the application development stage, including the design of the software configuration and software interfaces, coding, and testing.

(c) **Postimplementation-operation stage**—Paragraph 350-40-25-14 establishes that the postimplementation-operation stage begins when the software project is substantially complete and ready for its intended use, that is, after all substantial testing is complete. Paragraph 350-40-25-6 requires that training costs and maintenance costs during the postimplementation-operation stage are to be expensed as incurred. Typical activities undertaken in this stage include training and application maintenance (paragraph 350-40-55-3(c)).

Stakeholder Feedback

16. The staff received preliminary stakeholder feedback in response to the 2021 ITC and at the March 2022 Financial Accounting Standards Advisory Council (FASAC) meeting.

2021 ITC Feedback

17. Respondents consistently provided the following overall feedback:

(a) The increased prevalence of software costs across companies and a shift in how companies develop software from the traditional waterfall method to the agile development method have created a pervasive need for the Board to update the accounting for software costs. Respondents encouraged the Board to better align the accounting with how software is developed because the current guidance is outdated and lacks relevance given the evolution of the software industry.

(b) There should be no difference in how a company accounts for software developed for internal use and how a company accounts for software developed to be sold, leased, or otherwise marketed. That distinction in accounting guidance is not decision useful for investors and creates unnecessary complexity. Respondents generally agreed that the distinction is no longer relevant considering the evolution of the software industry and that there should be one principle and capitalization threshold for all software costs regardless of whether the software is internally used or will be sold, leased, or otherwise marketed.

18. Respondents cited numerous challenges with the guidance in Subtopic 350-40 and/or Subtopic 985-20, including:

    (a) **Significant judgment is required**—Companies find it challenging to evaluate which stage of development a company is in for internal-use software and whether technological feasibility has been reached for external-use software. Respondents also stated that assessing which costs are eligible for capitalization and whether the software is intended for internal or external use requires significant judgment and is challenging to apply and audit.

    (b) **Different capitalization thresholds between Subtopic 350-40 and Subtopic 985-20**—The differences in capitalization thresholds between Subtopic 350-40 and Subtopic 985-20 lead to different development costs if the software is delivered via the cloud or on premises, despite the fact that the process to develop the software may be similar for both software products.

    (c) **Accounting for upgrades and enhancements under Subtopic 350-40**—The definition of upgrades and enhancements as "modifications to enable the software to perform tasks that it was previously incapable of performing" in Subtopic 350-40 creates operational costs and burdens in a cloud-based software environment in which upgrades and enhancements are frequently released to customers because frequent upgrades and enhancements need to be separately tracked and assessed for capitalization. In contrast, Subtopic 985-20 requires a company to assess the enhancements against the concept of reaching technological feasibility, which typically will result in less cost capitalization.

    (d) **Lack of specific guidance for hybrid-cloud solutions**—There is no specific guidance for companies to account for hybrid-cloud solutions in which on-premises licensed software is enhanced with cloud-based capabilities. In certain circumstances, a company may be required to track which software costs are incurred for the development of the on-premises software (to be accounted for under Subtopic 985-20) and which costs are related to the cloud-based service (to be accounted for under Subtopic 350-40).

19. Respondents provided various suggestions for the Board to consider in improving the accounting for software costs:

    (a) Adopt the external-use software guidance for all revenue-generating software costs (that is, licensing and SaaS).

    (b) Adopt the internal-use software guidance for all software costs.

(c) Supersede the current software guidance and create a new capitalization model for all software costs, such as (i) a model based on IAS 38, *Intangible Assets*, or (ii) leveraging a capitalization threshold model utilized to account for tangible assets in GAAP.

(d) Require all software costs to be expensed as incurred as R&D costs under Topic 730, Research and Development.

(e) Permit companies to apply a policy election to expense all software R&D costs as incurred, either for all companies or for private companies.

(f) Consider software costs as part of a holistic project on the accounting for intangible assets.

(g) Develop implementation guidance with examples of how to apply the current software models when the costs are incurred in an iterative or agile development environment.

March 2022 FASAC Meeting

20. At the March 15, 2022 FASAC meeting, the staff discussed accounting for software costs with Council members. FASAC members provided the following feedback at that meeting:

(a) Similar to the feedback received in response to the 2021 ITC, preparers and practitioners noted that the current software guidance is outdated and requires a significant level of judgment and is challenging to apply. Specifically, preparers explained that with new software development methodologies, such as the agile method, the software development process does not have a clear beginning or end, and developers work and navigate between different stages quickly (in reference to internal-use software guidance). Preparers and practitioners also highlighted challenges with the accounting for hybrid-cloud solution arrangements and SaaS arrangements. Regarding possible improvements, Council members agreed that the software guidance should be updated to align with the evolution of the software industry, and some preparers suggested that additional implementation guidance should be considered.

(b) Council members generally viewed the accounting for and disclosure of software costs as an area in which the Board should consider improvements. Council members agreed that a potential project to address software costs should consider improving the guidance for both internal-use software and external-use software.

(c) Generally, investors expressed that internal-use and external-use software should not be capitalized using different models. However, some said that they may analyze costs related to the development of software differently.

(d) Overall, investors expressed the need for greater consistency and disaggregation to allow for a cleaner starting point for analysis. Several investors suggested that to fulfill this need, the Board could require all software costs to be expensed as incurred in the income statement with a requirement to disaggregate those costs. Regarding disaggregation, some investors stated that it would be beneficial to understand more about the nature of software costs and whether the software costs relate to enhancing or upgrading existing software or whether they relate to the development of new products or services.

Potential Project Objectives

21. On the basis of the staff's preliminary research, including the feedback received in response to the 2021 ITC, the staff has identified several potential project objectives. In addition to improving the decision usefulness of information provided to investors, the staff would like to understand which of the following additional potential project objectives Board members would be interested in pursuing and whether there are any objectives that Board members are not interested in pursuing:
    (a) Align the software capitalization models for external-use and internal-use software.
    (b) Reduce cost and complexity in applying the software guidance.
    (c) Amend the software guidance capitalization threshold models to reflect how software is developed today or how it may be developed in the future.
    (d) Provide implementation guidance for how current software guidance applies to different software development methodologies (such as the agile method).

Agenda Decision Criteria

22. When considering whether to add a project to the technical agenda, the Board evaluates potential projects against the following three criteria to ensure consistent agenda prioritization decisions:
    (a) **There is an identifiable and sufficiently pervasive need to improve GAAP—**What improvement is needed? To what extent does an issue affect investors, preparers, auditors, and others?
    (b) **There are technically feasible solutions, and the expected benefits of those solutions are likely to justify the expected costs of change—**What are the various alternative ways that an issue could be addressed? What are the expected benefits of the solutions, and can the solutions be implemented?
    (c) **The issue has an identifiable scope—**Can the FASB effectively identify the scope of a potential project? Can the issue be sufficiently described?

Board Meeting Handout

Distinguishing Liabilities from Equity—Phase 2

April 13, 2022

Meeting Purpose

1. The purpose of the April 13, 2022 Board meeting is to provide the Board with a summary of the research that has been completed since the February 2021 Board meeting on the Distinguishing Liabilities from Equity—Phase 2 project (the Phase 2 project), including feedback received on this area in connection with the June 2021 Invitation to Comment, *Agenda Consultation*, and as part of the staff's significant outreach efforts performed during 2021 and 2022. The staff will ask the Board whether it would like to proceed with the Phase 2 project (either with its current scope and objective or to revisit the scope and objective) or remove the project from the technical agenda.

Questions for the Board
1. On the basis of the staff's research performed related to feasible solutions and pervasiveness during 2021 and feedback received as part of the 2021 Invitation to Comment, would the Board like proceed with the Distinguishing Liabilities from Equity Phase 2 project or remove the project from the technical agenda? 2. If the Board would like to proceed with the Distinguishing Liabilities from Equity Phase 2 project, would the Board like to reconsider the project's scope and objective in a future meeting?

Phase 2 Project Background

2. The Phase 2 project is an offshoot of the Distinguishing Liabilities from Equity project (the Phase 1 project), which was intended to reduce complexity in applying generally accepted accounting principles (GAAP) for certain financial instruments with characteristics of liabilities and equity. At that time, the Board received feedback that stakeholders were having difficulty applying the liabilities and equity guidance because of its organization (guidance is included in multiple topics in the Codification), as well as that the current guidance is rules based, in certain cases is internally inconsistent, and often results in form-over-substance-based accounting conclusions. The Phase 1 project resulted in the issuance of Accounting Standards Update No. 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives*

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and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity, in August 2020.

3. As part of the Phase 1 project, the Board proposed adding a likelihood assessment to both the indexation and settlement determination in the derivative scope exception in paragraph 815-10-15-74(a) as part of the proposed Accounting Standards Update, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity,* which was issued on July 31, 2019.

4. Paragraph 815-10-15-74(a) contains a derivative scope exception whereby if an embedded feature or freestanding instrument passes the criteria in this paragraph, it would not be considered a derivative. One of the criteria to meet this scope exception is that the feature or instrument has to be indexed to an issuer's own stock and that guidance is contained in Subtopic 815-40. In Subtopic 815-40, whether an equity contract is indexed to an entity's own stock is a two-part analysis:

    (a) *Step 1:* Evaluate the instrument's contingent exercise provisions. Exercise provisions do not preclude an embedded feature or instrument from being considered indexed to an issuer's own stock as long as it is not based on an observable market, other than the market for the issuer's stock, or on an observable index, other than an index calculated or measured by reference to an issuer's own operations.

    (b) *Step 2:* Evaluate the instrument's settlement provisions. An embedded feature or instrument could be considered indexed to an entity's own shares if the settlement amount is equal to the difference between the fair value of a fixed number of an entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. In practice, provisions that adjust a settlement amount would not preclude an instrument or embedded feature from being indexed to an entity's own shares if it is affected by the fair value inputs of a forward or option on equity shares.

5. The proposed likelihood assessment would have allowed an entity to disregard features that have a remote likelihood of occurring in determining whether an instrument is indexed to the entity's own stock or if the entity could be required to settle its obligations in cash. The Board proposed adding this assessment to reduce some form-over-substance-based accounting conclusions and reduce complexity to attempt to reduce frequent financial statement restatements.

6. The remote threshold contemplated by the Board in the Phase 1 project received mixed feedback from stakeholders. While most stakeholders agreed that those features that had a remote likelihood of occurring should be disregarded for purposes of classifying contracts in an

entity's own equity, some expressed concerns about the operability of that threshold and also questioned whether the remote threshold went far enough in reducing form-over-substance-based conclusions to make a significant difference in applying the guidance.

7. Ultimately, the Board unanimously agreed that the remote threshold should not be affirmed. Rather, the Board decided to further consider improvements to the derivatives scope exception guidance in a separate project, which is currently the Phase 2 project.

8. At its August 26, 2020 Board meeting, the Board decided that the Phase 2 project objective would be to improve and align the two existing indexation models used to evaluate financial instruments with characteristics of equity by developing an indexation principle to reduce inconsistencies across GAAP. The Board decided at that meeting that the scope of the project would include the indexation guidance in Topic 480, Distinguishing Liabilities from Equity, and Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity. The scope is broader in some aspects than the Phase 1 project because it includes Topic 480 guidance (the Phase 1 project only focused on Subtopic 815-40) and also narrower in scope in some aspects because it focuses only on the indexation guidance (the Phase 1 project focused on both indexation and settlement aspects of the guidance).

9. At its February 3, 2021 Board meeting, the Board clarified the scope of the Phase 2 project by tentatively deciding that the scope would include freestanding financial instruments that have all the characteristics of a derivative instrument, freestanding instruments that potentially are settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument, and embedded features that have the characteristics of a derivative instrument. The Board also tentatively decided that the scope would include both Step 1 (exercise contingencies) and Step 2 (settlement provisions) of the Subtopic 815-40 indexation guidance. In addition, the Board directed the staff to develop alternatives for indexation that focus on both qualitative and quantitative thresholds, as well as instruments or features that are *not* indexed to an entity's own equity.

Recent Research Paths

10. The objective of the staff's research since the February 3, 2021 Board meeting has focused on identifying feasible solutions that would provide a meaningful improvement to the indexation guidance (and where the benefits would justify the costs) within the scope of the project set by the Board at its August 2020 Board meeting. During 2021, the staff identified the following four paths as a starting point to developing an aligned indexation model.

(a) *Valuation path*: This path describes indexation as linked to the value of an entity's shares. The general principle would be that if a contract's settlement amount is substantially (or a similar threshold) consistent with the value of the entity's shares, the contract would be considered indexed to an entity's own equity.

(b) *Ownership path*: This path describes indexation as linked to similar risks and rewards of an ownership interest. The general principle would be that if a contract results in a settlement amount that varies in a manner that provides similar risks or rewards as an ownership interest, the contract would be considered indexed to an entity's own equity.

(c) *Operations path*: This path describes indexation as linked to an entity's operations. The general principle would be that if a contract's settlement timing or amount is based on an entity's operations, the contract would be considered indexed to the entity's own equity.

(d) *Two-step path with screen*: The two-step path would begin with a screen that would disregard certain features so that only the substantive features of the instrument that affect its settlement amount would affect the conclusion of whether that instrument is indexed to an entity's own shares and recorded as equity. Any features screened out would not preclude a contract from being considered indexed to the entity's own shares. Potential screens under this path could include a screen based on magnitude, likelihood, and/or certain features.

Invitation to Comment Feedback

11. Question 23 of the 2021 Invitation to Comment asked respondents:

> Stakeholders noted many challenges in applying the liabilities and equity guidance, but they had mixed views on how the Board should improve the accounting for financial instruments with characteristics of equity. The Distinguishing Liabilities from Equity Phase 2 project is intended to align the two existing indexation models in Topic 480 and Subtopic 815-40. Should the Board continue pursuing this project in its current scope and objective, or does the Board need to reevaluate this project? Please explain why or why not and if the project scope and objective need to be reevaluated, what should the approach be?

12. Approximately 29 respondents, including practitioners, preparers, state societies, trade groups, and users provided feedback on Question 23. Overall, the feedback from stakeholders was mixed on whether the Board should continue with the project's current scope and objective.

13. A summary of the feedback is included in paragraphs 119–123 of the 2021 Invitation to Comment feedback summary.