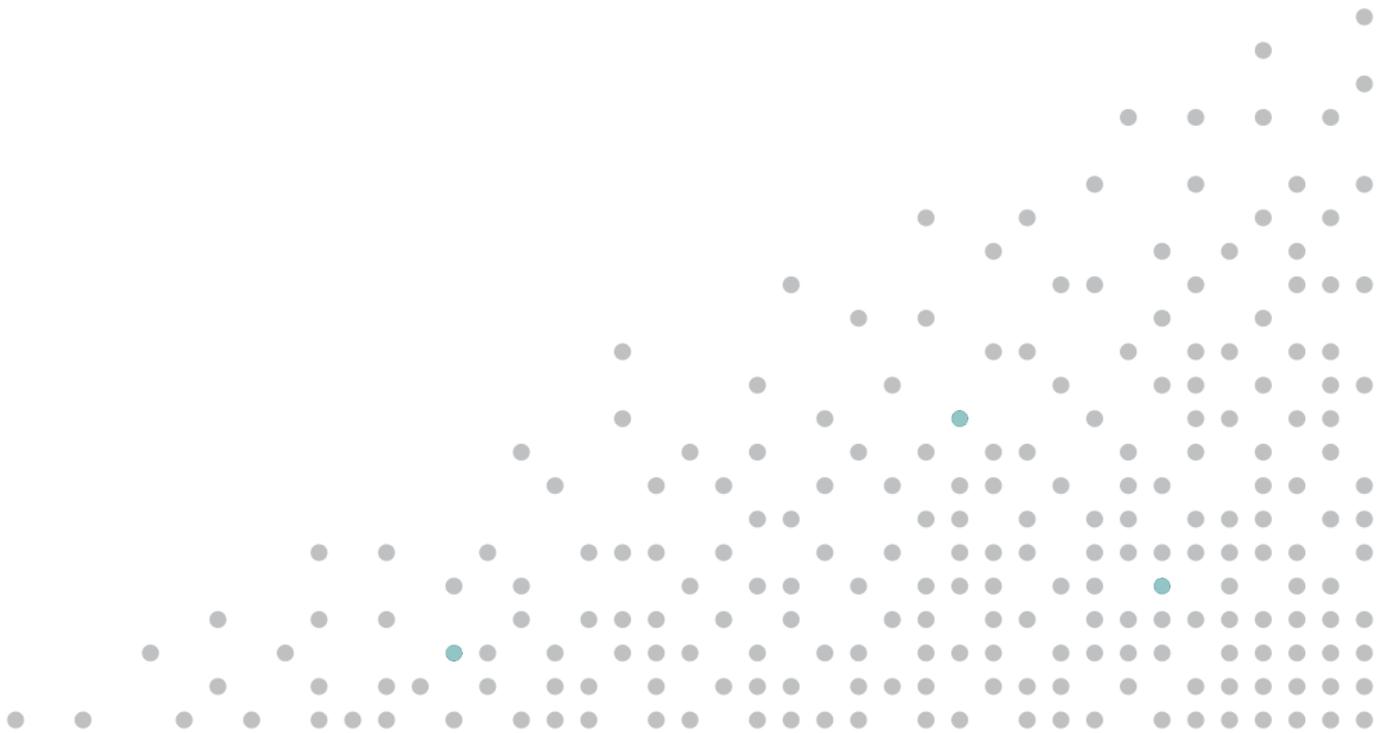




**Australian Government**  
**Department of Finance**



# **Accounting for internally developed software**

## **Resource Management Guide (RMG) 109**

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# Contents

<b>Accounting for internally developed software</b>	<b>1</b>
<b>Audience</b>	<b>4</b>
<b>Key points</b>	<b>4</b>
<b>Resources</b>	<b>4</b>
Introduction	5
<b>Part 1 – Accounting for IDS</b>	<b>6</b>
1.1 When to apply AASB 138 and AASB 116	6
1.2 Costs that can be capitalised	6
1.3 Costing IDS	7
1.4 Subsequent accounting	7
1.5 Cloud-based software	8
1.6 Disclosure requirements	8
<b>Part 2 – Budget implications</b>	<b>9</b>
<b>Appendix 1. Example - project cost allocations</b>	<b>10</b>
<b>Appendix 2. Illustrative example – costs to expense and capitalise</b>	<b>11</b>

## Audience

This guide is relevant to all officials in Commonwealth entities, particularly chief financial officers (CFOs) and finance teams, where the entity has developed software for its own internal use.

## Key points

This resource management guide (RMG) provides guidance on the costs a Commonwealth entity can capitalise for internally developed software (IDS).

IDS is software developed by the entity, or purchased by the entity but significantly modified, for the entity's internal use.

Internal use is where there is no substantive plan in existence, or being developed, to market the software externally during the software's development.

Intangible assets are identifiable non-monetary assets without physical substance (see paragraph 8 of AASB 138).

## Resources

This RMG is to be read in conjunction with:

- relevant [Australian Accounting Standards](#)
- [Australian Accounting Standards Board \(AASB\) 138 Intangible Assets](#) (AASB 138)
- [AASB 116 Property, Plant and Equipment](#) (AASB 116)
- [Interpretation 132 Intangible Assets – Web Site Costs](#)
- [AASB 136 Impairment of Assets](#).

## Introduction

1. Internally developed software (IDS) is software that is either:
  - developed by an entity, or
  - purchased and then significantly modified by an entity for internal use.
2. Internal use is where there is no substantive plan in existence, or being developed, to market the software externally during the software's development

### **Example:**

Systems Application and Product (SAP) financial management information systems are designed and modified by SAP and, therefore, are unlikely to meet the IDS definition.

3. All costs incurred during the research phase of generating IDS are expensed when they are incurred. Costs incurred during the development phase are capitalised if they meet the requirements set out in [AASB 138](#), otherwise the costs are expensed in the year undertaken.

## Part 1 – Accounting for IDS

### 1.1 When to apply AASB 138 and AASB 116

4. Generally, IDS is an intangible asset (ie an identifiable non-monetary asset without physical substance), accounted for under paragraph 8 of [AASB 138](#).
5. However, if the IDS is part of a larger asset, that has a significant physical component, and the larger asset could not operate without the software, then [AASB 116](#) applies. For such issues, entities may need to consider [Interpretation 132 Intangible Assets – Web Site Costs](#) issued by the AASB.

#### Example:

Computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment.

### 1.2 Costs that can be capitalised

6. Under [AASB 138](#), the generation of IDS separated into two phases. The:
  - **research phase**—which includes activities aimed at obtaining knowledge, evaluating alternatives and making selection decisions. In the research phase, all costs are expensed when they are incurred
  - **development phase**—includes activities that relate to design, construction and testing prior to the asset being available for use. In the development phase, costs incurred are capitalised if they meet the requirements set out in AASB 138, otherwise costs are expensed in the year undertaken
    - however, paragraph 57 of [AASB 138](#) specifies other requirements that must be met before costs arising from the development phase can be capitalised (in addition to those for intangible assets).

#### Practical guidance:

Paragraph 57(c) of [AASB 138](#) advises that an intangible asset arising from IDS development (or from the development phase of an internal project) is to be recognised if, and only if, an entity can demonstrate its ability to use or sell it.

However, entities should focus on their ability to use the asset rather than sell it because paragraph 57(d) of AASB advises that entities are not required to demonstrate the existence of a market but must demonstrate the usefulness of the intangible asset.

## 1.3 Costing IDS

7. Under paragraph 66 of [AASB 138](#), the cost of IDS comprises all directly attributable costs necessary to create, produce and prepare the asset, to be capable of operating as intended from the date the intangible asset moves into the development phase.
8. If an entity cannot distinguish the phase in which a project-related cost was incurred, then the expenditure is treated as if it were incurred in the research phase.

### Practical guidance:

Entities may require a level of judgment in the determination of costs as 'capital' or 'expense'. It is advisable that entities consult their auditors as part of this process.

9. As assets are initially measured at cost, entities require sufficiently robust costing systems to ensure costs can be reliably measured.

### Example:

Entity costing systems need to be able to measure the employee benefit costs attributable to the cost of IDS development. Items such as employee 'on costs' should be reasonable and there should be no profit margin.

10. [AASB 138](#) disallows costs that have previously been expensed from being capitalised at a later date.

### Practical guidance:

If an item has been classified as an expense in error, it can be subsequently capitalised during the same financial year, provided the recognition criteria in AASB 138 were met when the error occurred.

11. For more information on costing IDS, see the examples at:
  - **Appendix 1. Example - project cost allocations**—examples of cost allocations between expensing and capitalising costs for internally developed intangible asset
  - **Appendix 2. Illustrative example – costs to expense and capitalise**—illustrative example on whether to expense or capitalise.

## 1.4 Subsequent accounting

12. IDS is measured in accordance with the requirements of AASB 138 and section 17 of the [Public Governance, Performance and Accountability \(Financial Reporting\) Rule 2015](#).

### Practical guidance:

AASB 138 refers to the term 'amortisation' which, in effect, has the same meaning as 'depreciation'.

AASB 138 requires reference to an 'active market' for fair value measurement to apply. Under most circumstances, it would be unusual for there to be an 'active market' for such IDS. Therefore, it is unlikely that IDS will be measured at fair value.

13. Following the completion and implementation of IDS, it is generally rare for subsequent expenditure to be recognised in the carrying amount of the asset. Usually subsequent expenditure will be expensed.
14. Similar to other non-financial assets, IDS is subject to impairment (write-down) if the economic benefits of the system are unlikely to be realised in accordance with [AASB 136 \*Impairment of Assets\*](#). Entities need to be aware that:
  - intangible assets not yet available for use are to be tested for impairment annually
  - initially recognised intangible assets are to be tested for impairment before the end of the current annual period.

## 1.5 Cloud-based software

15. Implementation and development of cloud-based software uses the same principles discussed above for what can be capitalised and what should be expensed.
16. Cloud software license agreements can generally only be capitalised if:
  - there is a contractual right to take possession of the software at any time during the hosting period without significant penalty
  - the customer can feasibly either run the software on their own hardware or contract another party, unrelated to the vendor, to host the software.
17. In most situations, cloud-based software is considered to be a purchased hosting arrangement, accounted for as an expense.

## 1.6 Disclosure requirements

18. Paragraphs 118 to 128 of [AASB 138](#) set out disclosure requirements where IDS is an intangible asset.

## Part 2 – Budget implications

19. The following table illustrates the impact on budget aggregates at the research and development phases, and for impairment.

**Table: IDS budget implications**

Transaction	Fiscal Balance	Underlying Cash Balance
1. Research phase – expensing	Worsen (operating expenses reduce net operating balance)	Worsen (payments for employees and services are treated as an operating cash outflow)
2. Development phase – capitalising (work in progress / asset under construction)	Worsen (due to movement in non-financial assets (NFAs))	Worsen (investments in NFAs are treated as a cash outflow)
3. Capitalised as an operational / depreciable asset	Worsen (due to movement in NFAs)	Worsen/Nil impact (nil impact if no additional cash outflow at this stage, otherwise same as above)
4. Impairment – write down of the asset	Nil impact (no impact on net operating balance from operations or NFAs)	Nil impact (no cash inflow/outflow)

## Appendix 1. Example - project cost allocations

The following items are not exhaustive and assume that requirements to capitalise are met.

Item	Expense	Software – Capital (AASB 138)	Plant & Equipment – Capital (AASB 116)
<b>Research phase</b>			
User testing of existing software to inform a business case	✓		
Consultant fees	✓		
Staff costs	✓		
<b>Development phase</b>			
Off-the-shelf system		✓	
Consultant fees – design & construction		✓	
Depreciation of software licences & computers – specifically required to develop or test the asset		✓	
Equipment - other (printers, PCs, etc)			✓
Data migration costs – test data used for system testing		✓	
Data migration costs – outside of system testing	✓		
Project manager costs – planning data migration and/or training	✓		
Staff costs (including project managers) – development &/or testing		✓	
Contractor & supplier costs – development &/or testing		✓	
Staff costs (including project managers) – not directly related to the project (eg attending training)	✓		
Administration costs – not directly related to development	✓		
Project governance committees	✓		
Stakeholder meetings	✓		
Initial pilot system to test feasibility prior to developing the final system to be capable of being used by the entity		✓	
Inefficiencies in development (eg if an entity develops a system to provide xyz functionality, but subsequently decides to abandon the work on z, the costs related to z could not be capitalised)	✓		
<b>Implementation phase</b>			
Replacement of computer terminals – even if the old terminals could not accept the new software			✓
Training – staff costs	✓		
Advertising and promotional costs	✓		
Manuals (including their development at any phase)	✓		
Post-implementation reviews	✓		

## Appendix 2. Illustrative example – costs to expense and capitalise

### Example: IDS costs to expense and capitalise

#### Scenario:

An entity develops a new IT software program to record customer details.

The entity incurred the following costs to develop the new software:

- a) \$5,000 consultant fees to search and evaluate off-the-shelf systems
- b) \$2,000 in employee expenses to select the final off-the-shelf system
- c) \$3,000 in employee expenses to design changes required to the off-the-shelf system
- d) \$10,000 in employee expenses to construct and test the new software
- e) \$5,000 for new terminals to replace old terminals that did not have the capacity to handle the new software
- f) \$500 to promote the new software to staff
- g) \$2,000 in training staff to operate the new asset.

#### Treatment of costs – expense or capitalisation

Assuming the requirements to capitalise are met, these costs would be treated as follows:

- a) expense \$5,000 consultant fee—as it was incurred in the research phase
- b) expense \$2,000 employee expenses—as it was incurred in the research phase
- c) capitalise \$3,000 employee expenses—as it is directly attributable and was incurred in the development phase
- d) capitalise \$10,000 employee expenses—as it is directly attributable and was incurred in the development phase
- e) recognise as property, plant and equipment \$5,000 under AASB 116
- f) expense \$500 as it is an operating expense incurred in the implementation phase
- g) expense \$2,000 as it is an operating expense incurred in the implementation phase.