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An Analysis of Application of Accounting Standards to Computer Software and Website Cost

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ABSTRACT

Today's era is an era of machinery. Therefore, approximately all enterprises use machinery or equipments such as computers, machines for manufacturing, processing, packing etc., for the efficient and expeditious working. As the environment of every enterprise is different from each other, all the enterprises generally use internally generated assets which may benefit themselves. The computer software either acquired or internally generated for the purpose of internal use or a website either developed internally or purchased by the enterprise for the purpose of its internal use in the organization, may be recognized as an intangible asset. An expenditure incurred in respect of developing a website should be charged as an expense to the period to which it relates unless such expenditure comes under the purview of recognition criteria. Companies are incurring significant costs to develop Internet web sites. These companies may be "Internet" companies, traditional "brick and mortar" companies, or service companies. The web sites may be used to promote or advertise products or services supplant manual processes or services, sell products (including software) or services, or to do a combination of all three. Further, due to rapid changes in technology, new uses for web sites are being developed. Diversity in practice exists in accounting for website development costs. Some entities capitalize website development costs, others expense such costs, and still others capitalize some of those costs and expense the rest. Hence, the issue is how an entity should account for costs incurred to develop a computer software or website.

Keyword: *Internally Generated Software, Acquired software, Website cost, Intangible assets, Amortization, Capitalization*

1.1 INTRODUCTION

Assets are of two types – Tangible assets and Intangible Assets. Tangible assets are the assets having physical substance and can be seen and touched like – building, plant and machinery etc. But intangible assets are the assets that have no physical substance and hence cannot be touched or seen like – goodwill, patent, brands, and trademarks, research and development, computer software etc. The expenditure will come under the scope of an intangible asset only if it is identifiable, it has control over the resource and it has future economic benefits. If an enterprise acquires any computer software for the purpose of its use in the organization then such software will be recognized as an asset only when it is probable that will result in future economic benefits and its costs can be measured reliably. Similarly a website cost can be measured and attributed reliably based on the probable future economic benefits to the enterprise. Therefore, the choice of accounting for internal use of computer software and website cost is based on the company's accounting policy.

1.2 Objectives of this study

- Prescribing accounting treatment for software acquired for internal use.
- Prescribing accounting treatment for internally generated software.

- Prescribing accounting treatment for website cost.
- Recognition of subsequent expenditure.
- Method of amortization and capitalization.

1.3 Scope of an intangible asset

An amount of expenditure will come under the scope of intangible asset, only when it fulfills all the following criteria:

- Identifiable
- Non monetary asset and
- Without physical substance.

If, expenditure does not meet any of the above criteria then such expense will be treated as an expense and it will be totally charged to profit and loss account in the year of its incurrence.

Identifiable: An asset is said to be identifiable if it is separable from other assets. Further if the enterprise could rent, sell, exchange or distribute the specific future benefits of this asset used in revenue earning activity. For example, if an intangible asset is acquired with group of asset, the transaction may involve the transfer of legal rights that enable the enterprise to identify the intangible assets.

Non monetary Asset: Intangible assets are non monetary asset, which means the value received against this asset is not fixed by contract as in case of goodwill, patent, trademark etc.

Physical substance: Intangible asset has no physical substance. However, some intangible assets may have physical substance like compact disc containing computer software. Here the cost of physical substance is compared to intangible asset and if the cost of physical substance is more, then the asset is treated as per AS -10 'Fixed Asset' and not by this standard.

1.4 Accounting for internal use of computer software

For the purpose of accounting, an enterprise has to recognize, whether the computer software is either acquired or internally generated for the purpose of its use in the organization.

- ***Accounting for software acquired for internal use***

If an enterprise acquires any computer software for the purpose of its use in its organization then such software will be recognized as an asset only when it is probable that it will result in future economic benefits and its cost can be measured reliably.

- ***Accounting for internally generated software***

An enterprise can develop computer software for the purpose of its internal use in the organization, so that it may be generated as per the requirements of the enterprise. For the purpose of recognition of internally generated software, the expenditure incurred in respect of generation of software is distinguished between the expenditure incurred during research phase and development phase. Any expenditure incurred during the research phase is recognized as an expense in the period in which it is incurred, whereas any expenditure incurred during the development stage is recognized as an asset only when such expenditure meets the recognition criteria.

- ***Research Phase***: Any expenditure incurred during the research phase should be charged as an expense in the period in which these have incurred in the financial statement as these assets will not generate future economic benefits to the enterprise.

- ***Development phase***: Any expenditure incurred during the development phase should be recognized as an asset only when cost can be measured reliably and the future economic benefit to the enterprise is certain. The reasonable and supportable assumptions in respect of probability of future economic benefits may include the following events:

    - Where it is technically feasible that the internally generated computer software will be available for internal use for the enterprise
    - The enterprise is intending to use that software for the defined purposes and within its organization.
    - The enterprise is able to use that software within its organization.
    - The software is useful and befitting to the circumstances prevailing in the enterprise and

- All the resources required for the development and installation of internally generated computer software are adequate.

- ***Cost of internally generated software***

Any expenditure incurred after meeting the recognition criteria i.e cost can be reliably measured and future economic benefits to the enterprise can be probably estimated, in respect of internally generated software, should be recognized as an asset and any expenditure incurred prior to that period should be recognized as an expense in the period of its incurrence. However, after recognition of expenditure as expense, if an asset comes under the purview of recognition criteria then such expenditure should not be reversed back and reinstated.

- ***Recognition of subsequent expenditure***

Any expenditure incurred after installation or put to use of the computer software either purchased or internally generated should be recognized as an expense in the period of its incurrence. However, if such expenditure meets the following criteria then it should be added to the carrying amount of the existing software, the criteria is

a. Cost can be measured and attributed to the software reliable; and
b. Such expenditure increases the future economic benefits to be achieved from the original software to the enterprise.

Any expenditure incurred for restoration or maintenance of future economic benefits to be achieved from the existing software system is recognized as an expense at the time of completion of restoration or maintenance work.

- ***Amortization period for internal use of computer software***

Amortization period means the estimated useful life of internal use computer software for which such software will be used by the enterprise. Such useful life should be determined on the basis of technological obsolescence. Amortization period should be calculated because the depreciable amount is allocated or amortized over the amortization period, of any internal use computer software. Amortization should be started from the period from which the asset is available for use.

As per AS-26, the amortization period of any intangible asset should not exceed 10 years except under certain circumstances from the date when the asset is available for use. However, the amortization period of any computer software should be shorter than 5 years because of the fast technological changes.

For example: XYZ Ltd. acquired specialized software on 1st April, 2000 for Rs.14 lakhs and writes off the same over a 5 year period. Under AS-26, applicable to the company from 1.04.2003, the useful life is estimated as 7 years only. How it is accountable under the standard?

- **Situation**: useful life of Intangible asset has not expired and the enterprise amortizes the intangible asset over a period and as per the enterprise's accounting policy, remaining amortization period is shorter than the balance useful life.

- **Analysis**: Amortization period for software under AS - 26 is 7 years from 1.04.2000. However, the company has decided to write off the same within 5 year period. The amortization period has not expired, when AS - 26 is applicable for the enterprise.

- **Time period differences**: Remaining useful life as per AS-26 as on 1.4.2003 = Total useful life (7 years) – Life elapsed up to 1.4.2003 (3years) = 4 years. However, remaining useful life as per the company's accounting policy = 5 years – 3 years = 2 years. This is shorter than the period determined under AS-26.

. **Treatment**: The Company should continue its existing amortization policy, i.e writes off the carrying amount of software over the balance period of 2 years.

- ***Method of amortization of carrying amount of internal use computer software***

Depreciable amount of any internal use of computer software can be amortized by using any adequate method out of the methods available for amortization, e.g., straight line method, diminishing balance method, unit of production method, etc. However, while selecting any adequate method, it should be taken into consideration that such method reflects the pattern in which the asset's economic benefits are consumed by an enterprise. Once any method is selected it should be applied consistently from period to period unless any change is required as per the statute or any accounting standard. In case where any method cannot be selected reliably then straight line method should be used by the enterprise for amortization.

➢ *Capitalization of software development costs*

Software capitalization involves the recognition of internally-developed software as fixed assets. Software is considered to be for internal use when it has been acquired or developed only for the internal needs of a business. Examples of situations where software is considered to be developed for internal use are:

- Accounting systems
- Cash management tracking systems
- Membership tracking systems
- Production automation systems

Further, there can be no reasonable plan to market the software outside of the company. A market feasibility study is not considered as a reasonable possible marketing plan. However, a history of selling software that had initially been developed for internal use creates a reasonable assumption that the latest internal-use product will also be marketed for sale outside of the company.

➢ *Software Capitalization Accounting Rules*

The accounting for internal-use software varies, depending upon the stage of completion of the project. The relevant accounting is:

- ***Stage 1: Preliminary*** - All costs incurred during the preliminary stage of a development project should be charged to expense as incurred. This stage is considered to include making decisions about the allocation of resources, determining performance requirements, conducting supplier demonstrations, evaluating technology, and supplier selection.
- ***Stage 2: Application development*** - Capitalize the costs incurred to develop internal-use software, which may include coding, hardware installation, and testing. Any costs related to data conversion, user training, administration, and overhead should be charged to expense as incurred. Only the following costs can be capitalized:
    - Materials and services consumed in the development effort, such as third party development fees, software purchase costs, and travel costs related to development work.
    - The payroll costs of those employees directly associated with software development.
    - The capitalization of interest costs incurred to fund the project.
- ***Stage 3. Post-implementation*** - Charge all post-implementation costs to expense as incurred. Samples of these costs are training and maintenance costs.

Any allowable capitalization of costs should begin after the preliminary stage has been completed as management commits to funding the project. It is probable that the project will be completed, and the software will be used for its intended function.

The capitalization of costs should end when all substantial testing has been completed. If it is no longer probable that a project will be completed, stop capitalizing the costs associated with it, and conduct impairment testing on the costs already capitalized. The cost at which the asset should then be carried is the lower of its carrying amount or fair value (less costs to sell). Unless there is evidence to the contrary, the usual assumption is that uncompleted software has no fair value.

➢ *Accounting for website costs*

As per AS -26, intangible asset means an identifiable non – monetary asset, without physical substance, held for use in production or supply of goods and services, for rental to others, or for administrative purposes. Therefore, as per this definition, a website either developed internally or purchased by the enterprise for the purpose of its internal use in the organization, may be recognized as an intangible asset. Website may be used for promoting and advertising product and services, providing electronic services, and selling product and services.

An expenditure incurred in respect of developing, enhancing and maintaining a website should be charged as an expense to the period to which it relates unless such expenditure comes under the purview of recognition criteria, i.e., cost can be measured and attributed reliably and probable future economic benefits to the enterprise, can be estimated on a reasonable and supportable ground as a consequence of such expenditure.

- ***Amortization period of a website***

The depreciable amount of internally generated website should be allocated over its useful life starting from the period in which the website is available for use by the enterprise. Useful life of website should be determined on the basis of technological obsolescence and at the today's time of rapid technological changes such period should be lower than 3 to 5 years. However, as per AS – 26, amortization period of any intangible asset should not exceed 10 years.

- ***Method of amortization of website***

Depreciable amount of internal use website may be allocated over its useful life by applying any method such as straight line method, reducing balance method etc., which may be suitable to the enterprise on the basis of the pattern in which the asset's economic benefits are consumed by the enterprise. Amortization method should be used consistent from period to period unless change is required as per any accounting standard or statute. Amortizable amount should be recognized as an expense to the period to which it relates.

This standard requires the capitalization of the cost of internal use software whether it is purchased, or internally developed. Such software serves the same purposes and functions as an operating asset. This standard provides for guidance regarding the types of cost elements to capitalize the timing and thresholds of capitalization, amortization periods, accounting for impairment, and other guidance. Our economy is changing from a focus on manufacturing processes (tangible outputs) to a focus on information flow (intangible outputs). As a result, the accounting for computer software products becomes increasingly important. "It's unreasonable to expense all software costs, and it's unreasonable to capitalize all software costs," is the opinion of IBM's director of financial reporting.

Indian Accounting Standards - Ind AS – 38 – its applicability to computer software and website costs.

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a license or patent) or film. In determining whether an asset that incorporates both intangible and tangible elements should be treated under Ind AS 16, Property, Plant and Equipment, or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant. For 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. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Issue:

1. An entity may incur internal expenditure on the development and operation of its own web site for internal or external access. A web site designed for external access may be used for various purposes such as to promote and advertise an entity's own products and services, provide electronic services, and sell products and services. A web site designed for internal access may be used to store company policies and customer details, and search relevant information.

2. The stages of a web site's development can be described as follows:

(a) Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences.

(b) Application and Infrastructure Development – includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing.

(c) Graphical Design Development – includes designing the appearance of web pages.

(d) Content Development – includes creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site before the completion of the web site's development. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed, the Operating stage begins. During this stage, an entity maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. When accounting for internal expenditure on the development and operation of an entity's own web site for internal or external access, the issues are:

(a) Whether the web site is an internally generated intangible asset that is subject to the requirements of Ind AS 38;

(b) The appropriate accounting treatment of such expenditure.

5. This Appendix does not apply to expenditure on purchasing, developing, and operating hardware (eg web servers, staging servers, production servers and Internet connections) of a web site. Such expenditure is accounted for under Ind AS 16. Additionally, when an entity incurs expenditure on an Internet service provider hosting the entity's web site, the expenditure is recognised as an expense under paragraph 88 of Ind AS 1 and the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards issued by The Institute of Chartered Accountants of India when the services are received.

6. Ind AS 38 does not apply to intangible assets held by an entity for sale in the ordinary course of business (see Ind AS 2 and Ind AS 115) or leases that fall within the scope of Ind AS 17. Accordingly, this Appendix does not apply to expenditure on the development or operation of a web site (or web site software) for sale to another entity. When a web site is leased under an operating lease, the lessor applies this Appendix. When a web site is leased under a finance lease, the lessee applies this Appendix after initial recognition of the leased asset. Accounting Principles

7. An entity's own web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of Ind AS 38.

8. A web site arising from development shall be recognised as an intangible asset if, and only if, in addition to complying with the general requirements described in paragraph 21 of Ind AS 38 for recognition and initial measurement, an entity can satisfy the requirements in paragraph 57 of Ind AS 38. In particular, an entity may be able to satisfy the requirement to demonstrate how its web site will generate probable future economic benefits in accordance with paragraph 57 (d) of Ind AS 38 when, for example, the web site is capable of generating revenues, including direct revenues from enabling orders to be placed. An entity is not able to demonstrate how a web site developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, and consequently all expenditure on developing such a web site shall be recognised as an expense when incurred.

9. Any internal expenditure on the development and operation of an entity's own web site shall be accounted for in accordance with Ind AS 38. The nature of each activity for which expenditure is incurred (eg training employees and maintaining the web site) and the web site's stage of development or post-development shall be evaluated to determine the appropriate accounting treatment.
For example:

(a) The Planning stage is similar in nature to the research phase in paragraphs 54-56 of Ind AS- 38. Expenditure incurred in this stage shall be recognised as an expense when it is incurred.

(b) The Application and Infrastructure Development stage, the Graphical Design stage and the Content Development stage, to the extent that content is developed for purposes other than to advertise and promote an entity's own products and services, are similar in nature to the development phase in paragraphs 57-64 of Ind AS 38. Expenditure incurred in these stages shall be included in the cost of a web site recognised as an intangible asset in accordance with paragraph 8 of this Appendix when the expenditure can be directly attributed and is necessary to creating, producing or preparing the web site for it to be capable of operating in the manner intended by management. For example, expenditure on purchasing or creating content (other than content that advertises and promotes an entity's own products and services) specifically for a web site, or expenditure to enable use of the content (e.g. a fee for acquiring a license to reproduce) on the web site, shall be included in the cost of development when this condition is met. However, in accordance with paragraph 71 of Ind AS 38, expenditure on an intangible item that was initially recognised as an expense in previous financial statements shall not be recognised as part of the cost of an intangible asset at a later date (e.g. if the costs of a copyright have been fully amortised, and the content is subsequently provided on a web site).

(c) Expenditure incurred in the Content Development stage, to the extent that content is developed to advertise and promote an entity's own products and services (e.g. digital photographs of products), shall be recognised as an expense when incurred in accordance with paragraph 69(c) of Ind AS 38. For example, when accounting for expenditure on professional services for taking digital photographs of an entity's own products and for enhancing their display, expenditure shall be recognised as an expense as the professional services are received during the process, not when the digital photographs are displayed on the web site.

(d) The Operating stage begins once development of a web site is complete. Expenditure incurred in this stage shall be recognised as an expense when it is incurred unless it meets the recognition criteria in paragraph 18 of Ind AS 38. 10 A web site that is recognised as an intangible asset under paragraph 8 of this Appendix shall be measured after initial recognition by applying the requirements of paragraphs 72-87 of Ind AS 38. The best estimate of a web site's useful life should be short.

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