

The NDH Group, Ltd.

July, 2006

Overview & Objective – The purpose of this TIA is to review current GAAP as it applies to the capitalization of costs related to internally developed software. As a general framework, software development costs are considered in “preliminary,” “post-preliminary” or “post-implementation” stages.

General Application – Costs associated with long-lived assets are accounted for as capital items rather than expensed or written-off. Practically, this means certain costs are included on the Balance Sheet and thought to provide benefit beyond the next year. Further, this treatment applies to *certain types of internally developed computer software* (SOP 98-1). Capitalizing computer software allows a company to amortize development costs –providing a near-term boost to the results shown on a P & L statement.

Determining If Capitalization Applies – Costs associated with developing computer software should be capitalized if they meet the three following criteria:

1. The software is developed to meet internal needs (does not exclude “customer facing” aspects of the software or the ability of the customer to share information).
2. There are no plans to market the software externally.
3. Management believes any distinct software project will be completed.

Determining When to Capitalize – If capitalization applies, then a determination must be made as to *when* to capitalize costs. The following outlines project stages and the conditions for each.

Expensing Vs. Capitalization of Software Development Costs		
Phase	Preliminary Project Stage	Post-Preliminary Project Stage
Conditions	<ul style="list-style-type: none"> • Lack of conditions as suggested in post-preliminary project stage 	<ul style="list-style-type: none"> • Management believes completion of software project is probable • Conceptual formulation and design is complete • Testing of alternatives is complete
Treatment	Expensed as R & D (as incurred)	Capitalized (as incurred)

Determining What Costs to Capitalize – Only certain costs associated with software development are capitalized. They include the following:

- External direct costs of materials and services
- Payroll and payroll-related costs
- Interest costs
- **Indirect costs**, including G & A, training, or other overheads **are not** capitalized.

Duration & Timing Amortization Period – The expensing or *amortization* of internally developed software should comply with the following duration and timing rules:

- Duration – Amortization should match the software’s estimated useful life.
- Timing – Amortization should begin after testing of the software is complete.

Determining If Capitalization Applies to Upgrades and Enhancements – After the software is implemented (**or after the post-preliminary project stage**) a determination must be made to capitalize or expense upgrades and enhancements. The following outlines the conditions for each.

Expensing Vs. Capitalization of Upgrades and Enhancements		
Phase	Post-Implementation Stage	Post-Implementation Stage
Conditions	<ul style="list-style-type: none"> • Training for Use of Software • Application Maintenance 	<ul style="list-style-type: none"> • New software specifications are created and changes to existing specs are made • Modifications result in add. functionality
Treatment	Expensed as R & D (as incurred)	Capitalized (as incurred)

Further Instruction & Use – For further information regarding capitalization of costs related to internally developed software contact your Account Executive or call The NDH Group, Ltd. at 312.461.0505.