

FASB ISSUES TARGETED IMPROVEMENTS TO INTERNAL-USE SOFTWARE ACCOUNTING GUIDANCE

SEPTEMBER 2025

SUMMARY

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2025-06, *Targeted Improvements to the Accounting for Internal-Use Software*, to modernize the guidance in Accounting Standards Codification (ASC) 350-40, *Intangibles – Goodwill and Other – Internal-Use Software*, to better align with current software development practices, including agile methodologies.

Key amendments include:

- ▶ Replace the “project stage” model with a principles-based framework for cost recognition and capitalization.
- ▶ Incorporate website development guidance from ASC 350-50, *Intangibles – Goodwill and Other – Website Development Costs*, into the new internal-use software framework.
- ▶ Clarify disclosure requirements for capitalized software costs.
- ▶ Retain existing treatment for external-use software costs.

BACKGROUND

ASC 350-40 requires an entity to consider project stages in determining whether a software development cost for internal-use software is capitalized or expensed. That accounting model aligns with linear, stage-based software development methods like the waterfall approach. However, most entities now use agile or iterative software development methods, which causes challenges in applying the existing accounting model and determining when to begin capitalizing internal-use software costs.

In response to the change in business practices, the ASU removes all references to project stages in ASC 350-40 and provides a principles-based recognition threshold to determine capitalizable software costs. Eliminating outdated references to project stages is expected to improve operability of the guidance across different software development methods.

No changes were made to the external use software guidance in ASC 985-20, *Software – Costs of Software to Be Sold, Leased, or Marketed*.

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MAIN PROVISIONS

MAIN PROVISION	SUMMARY
Capitalization criteria	An entity must start capitalizing internal-use software costs when both of the following occur: ▶ Management authorizes and commits funding for the software project. ▶ It is probable the project will be completed and the software will be used to perform the function intended ("probable-to-complete recognition threshold").
Significant development uncertainty	The probable-to-complete recognition threshold is not met until significant uncertainty associated with the development activities of the software ("significant development uncertainty") has been resolved. If significant development uncertainty exists, the entity must defer capitalization of internal-use software costs. In determining whether significant development uncertainty exists, an entity considers whether either of the following factors is present: ▶ The software being developed has novel, unique or unproven technology, functions, or features, and related uncertainty remains unresolved through coding and testing. ▶ The entity has not clearly defined the significant performance requirements of the software being developed or continues to make major changes to those requirements. The term "performance requirements" is defined as "what an entity needs the software to do (for example, functions or features)," which is consistent with the current definition of performance requirements in the preliminary project stage.
Removal of project stages	The ASU removes references to prescriptive, sequential software development stages such as "preliminary," "application development," and "post-implementation" stages. This change makes the guidance neutral to development methods and more adaptable to iterative processes.
Website development costs	The ASU supersedes the previous guidance for website development costs in ASC 350-50 and incorporates the recognition requirements for website-specific development costs into ASC 350-40, aligning it with the new guidance for internal-use software.
Disclosures	▶ An entity must apply disclosure requirements in ASC 360-10, <i>Property, Plant, and Equipment</i>, to all capitalized internal-use software costs and related amortization, regardless of financial statement presentation. ▶ An entity need not provide intangible asset disclosures in ASC 350-30, <i>Intangibles – Goodwill and Other - General Intangibles Other than Goodwill</i>, for internal-use software costs.

BDO INSIGHTS: ACCOUNTING FOR INTERNAL-USE SOFTWARE COSTS

The ASU introduces new areas of judgment in determining whether and when to capitalize software costs based on the facts and circumstances including whether the probable-to-complete recognition threshold is met or significant development uncertainty exists. Additionally, in applying the probable-to-complete recognition threshold, entities will need to apply judgment to determine what constitutes a software project - a new product, a distinct module, or a major feature or function to an existing product.

The ASU does not change the accounting guidance in ASC 985-20, nor add incremental disclosures related to costs incurred to develop software to be sold or licensed.

BDO INSIGHTS: ACCOUNTING FOR SOFTWARE COSTS UNDER ASC 350-40 AND ASC 985-20

By including the concept of significant development uncertainty, the ASU results in more alignment between the accounting outcomes under ASC 350-40 and ASC 985-20. As a result, the FASB noted that it expects more software development costs may be expensed under the revised guidance in ASC 350-40. However, while the models in ASC 350-40 and ASC 985-20 are expected to result in similar accounting outcomes in many instances, differences in capitalization thresholds might continue to exist between the two models because of certain nuanced differences in the guidance.

The ASU also provides examples to illustrate application of the amendments – see the Appendix.

EFFECTIVE DATE AND TRANSITION

The following table summarizes transition for ASU 2025-06:

APPLICABLE TO ALL ENTITIES	
Effective date	Annual reporting periods beginning after December 15, 2027, including interim reporting periods within those annual reporting periods.
Early adoption	Permitted at the beginning of an annual reporting period.
Transition	An entity must select one of the three transition approaches: ▶ Prospective approach: Apply amendments to new software costs incurred after the adoption date for all projects, including in-process projects, as of the beginning of the period of adoption. ▶ Modified prospective approach: Apply amendments prospectively to new software costs. For in-process projects that do not meet the new capitalization requirements but had met the requirements in current guidance, derecognize capitalized costs through a cumulative-effect adjustment to opening retained earnings (or other appropriate equity/net asset components), as of the date of adoption. ▶ Retrospective approach: Recast comparative periods and recognize a cumulative-effect adjustment to opening retained earnings (or other appropriate equity/net asset components) as of the beginning of the first period presented.
Transition disclosures	An entity must provide specific disclosures based on the transition method selected: ▶ Prospective Approach: Disclose the nature and reason for the change in accounting principle in both interim (if applicable) and annual reporting periods, as required by ASC 250-10-50-1(a). ▶ Modified Prospective Approach: Disclose the nature and reason for the change (ASC 250-10-50-1(a)) and the cumulative effect of the change on retained earnings at the beginning of the annual reporting period in which the ASU is adopted, in both interim (if applicable) and annual reporting periods. ▶ Retrospective Approach: Provide full transition disclosures under ASC 250-10-50-1(a) through (b)(1), (b)(2) for adjusted prior periods, and (b)(3), (c)(2) in both interim (if applicable) and annual reporting periods.

BDO INSIGHTS: NO DELAY IN ADOPTION DATE FOR PRIVATE COMPANIES

The ASU is effective for annual reporting periods beginning after December 15, 2027, for all entities, including interim periods within those annual periods. The FASB noted in the Basis for Conclusions¹ that it provided a delayed effective date to accommodate public companies' efforts to adopt other standards, primarily the newly required disclosure of disaggregated expense information required for public reporting entities². Thus, while comment letter respondents generally supported providing additional time for private companies to adopt the new standard, the FASB concluded that no additional delay in adoption was necessary as many private companies do not issue GAAP-compliant financial statements on an interim basis and the changes in ASU 2025-06 are not expected to require significant time or costs to implement.

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Link to [ASU 2025-06](#)

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¹ Paragraphs BC108 through BC110.

² ASU 2024-03, *Income Statement - Reporting Comprehensive Income - Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*

APPENDIX: EXAMPLES

EXAMPLE 1: [ADAPTED FROM ASC 350-40-55-5 THROUGH 55-8] IMPLEMENTATION AND CUSTOMIZATION OF AN ENTERPRISE RESOURCE PLANNING SYSTEM

FACTS

- ▶ On February 1, 20X3, a professional services company starts planning to upgrade its IT systems by implementing an enterprise resource planning (ERP) system. The ERP system supports finance, human resources, accounting, and client relationships functions.
- ▶ After evaluating different solutions, management signed a contract with a third party on August 1, 20X3, to implement and customize a hybrid ERP solution that offers on-premises software and cloud computing services.
- ▶ The third party offers various functions and features. The company will make customization decisions throughout the development process to select from existing functions and features.

CONCLUSION

The company starts capitalizing eligible software implementation and customization costs as of August 1, 20X3.

ANALYSIS

The company evaluates whether the internal and external costs to implement and customize the ERP system meet the capitalization criteria under ASC 350-40-25-12 through 25-12A:

- ▶ The company determines that significant development uncertainty does not exist as of August 1, 20X3 because:
 - It has identified the significant performance requirements and expects no substantial revisions, since customization involves selecting from existing functions and features.
 - The company selects a pre-developed solution with no novel, unique, or unproven functions or features.
- ▶ The company evaluates when to begin capitalizing software costs and determines:
 - Management authorized and committed to funding the software project on August 1, 20X3, by executing the contract with the third party.
 - Based on all relevant facts and circumstances such as engaging an experienced third party to implement and customize the software, the software project is probable-to-complete and the software will perform as intended.
- ▶ As a result, on August 1, 20X3, the company begins capitalizing:
 - Costs to implement and customize the on-premises software license, and
 - Costs to implement the cloud computing service features included in the hybrid solution.

EXAMPLE 2: [ADAPTED FROM ASC 350-40-55-13 THROUGH 55-17] DEVELOPMENT OF A NOVEL TECHNOLOGY FACTS

- ▶ On January 1, 20X1, a software development company starts discussions to develop software with novel functionality.
- ▶ On February 1, 20X1, management completes its due diligence procedures, approves a budget for internal development, and assigned an internal team to start developing the novel software. At that time, the software still included novel functionality.
- ▶ On March 1, 20X3, the company resolves the uncertainty related to the novel functionality through coding and testing. Additionally, on March 1, 20X3, management confirms that it has identified significant performance requirements – the significant functions and features – of the software and does not expect substantial changes.
- ▶ On April 1, 20X3, the company determines that all substantial testing is completed.

CONCLUSION

The company starts capitalizing eligible software development costs on March 1, 20X3, and stops capitalizing costs on April 1, 20X3, when the software is substantially complete and ready for use.

ANALYSIS

The company evaluates whether the internal and external costs to develop the software meet the capitalization criteria under ASC 350-40-25-12 through 25-12A:

- ▶ As of February 1, 20X1, the company determines that significant development uncertainty exists because:
 - It has not yet identified the significant performance requirements.
 - The software includes novel functionality that has not yet been resolved through coding and testing.Therefore, the company cannot begin capitalizing software costs as of February 1, 20X1.
- ▶ As of March 1, 20X3, the company determines that significant development uncertainty no longer exists because:
 - It has identified the significant performance requirements and does not expect substantial revisions.
 - It has resolved the uncertainty related to the novel functionality through coding and testing.
- ▶ On March 1, 20X3, the company evaluates when to begin capitalizing software costs and determines:
 - Management authorized and committed to funding the software project on February 1, 20X1.
 - The software project is probable-to-complete and the software will perform as intended, based on all relevant facts and circumstances.
- ▶ As a result, on March 1, 20X3, the company begins capitalizing eligible software costs.
- ▶ On April 1, 20X3, the company determines that the software project is substantially complete and ready for its intended use because all substantial testing has been completed. Therefore, the company stops capitalizing software costs on April 1, 20X3.