An accountant's perspective

Internal costs – to capitalise or not to capitalise?

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The internal costs mini-series – what to expect

Costs with respect to payroll and overheads may be incurred by a business to develop an asset which will be used in future, e.g. agile IT development for a piece of software. How these costs are treated can differ from an accounting or a tax perspective. This mini-series delves into this topic to share these different perspectives, starting with this, an accountant's perspective of internal costs and whether or not to capitalise.

Taking it back to basics – what do the accounting standards say?

The accountants amongst us are governed by Australian Accounting Standards Board 138 – **Intangible Assets** when it comes to thinking about how to treat these internal costs. This guidance basically says that these costs can be capitalised and held on the balance sheet, rather than expensing them through the income statement, if:

✓ They result in identifiable assets which will generate expected 'future economic benefits' for your company
✓ The time and costs used to generate the asset can be determined reliably, which may not be the case if they are not easily distinguishable from time and costs spent maintaining assets (like fixing a bug in your internally generated software) or in the running day-to-day operations (like an IT developer's time spent doing general training or going on holiday).

Future economic benefits

In practice for your company, this essentially means that this asset that you capitalise will ultimately result in either:

Additional revenue: An example of this could be an internally generated software asset that is being used to deliver a service to your customers, much like a fixed asset would do, or

Cost savings: For example, the use of intellectual property in a production process that would reduce future production costs.

The idea with these costs spent on developing internally generated assets is that your company could quite easily go out and buy a similar asset, for example a bespoke piece of software from an IT developer. That said, a company would only normally spend money on an asset from a third party if it thought that it was going to increase its future economic benefit in some way… otherwise why buy it?!

The price paid for this asset on an active market to a third-party vendor is also a fairly clear indicator of its fair value. Contrastingly there is some complexity and judgement in accounting for the generation and pricing of an internally generated asset, which is covered further in the next sections below.

In fact, if the recognition criteria are met to capitalise these internal costs, they must be capitalised, that is to say they cannot be written off upfront through the income statement.

Research and development – are both capitalisable?

There is a clear distinction regarding the accounting treatments of research and development spent:

Research: Since you don't know at the research phase if you have an asset that would result in 'future economic benefits' flowing to the entity, then all such expenditure must be expensed.

Development: If you are in the development phase, the standard requires the following criterion be met in order to capitalize costs and create an asset:

- your project must be technically feasible so that it can be used or sold as intended, for example, the pre-production testing of a new model of motor by a car manufacturer must show that the car would be road-worthy
- you must intend to complete the project and use or sell the resulting asset, for example, it must be in-line with your company's strategy and objectives
- you must have the ability to use or sell the resulting asset, for example, you must have any appropriate intellectual property or licences, if applicable
- you must be able to show that the project will generate that 'probable future economic benefit'. You can generally do this by demonstrating the existence of a market to sell the resulting asset. Or if the resulting asset will be used internally, you must be able to show how it will be useful to your business.
- you must have sufficient technical, financial and other resources to complete the development and to use or sell the resulting asset, for example, ability to secure the money to support a novel drug through clinical trials
- you must be able to reliably measure your costs in the development phase of this project, for example timesheets.

Unfortunately, if you cannot distinguish between the research and development phases of your internal project, all costs have to be expensed as incurred.

You cannot go back and capitalise research costs that were initially expensed, for example, after you can prove technical feasibility.

My internal costs meet all the capitalisation criteria, what costs am I supposed to capitalize?

You basically capitalize any 'directly attributable' costs that you need to spend to get the asset into working order. See the handy table below:

Capitalised costs	Expensed costs
The cost of any materials or services used.	Any selling, administrative or other general overheads.
Payroll costs for time employees spend creating the asset.	Any losses before the asset gets to planned performance.
Any legal fees, patents and licences or that kind of thing.	Any costs on training staff to learn how to use the asset.

What happens with expenditure incurred after the initial recognition of an internally generated intangible asset?

Only rarely will such subsequent expenditure be recognised in the carrying amount of an asset. Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally acquired or internally generated) is always recognised in profit or loss as incurred.

So do these costs ever go through the income statement?

Fast forward, and you now have an asset that is fully complete and ready to start giving you these economic benefits! The resulting cost of the asset now has to be recognised through the income statement over the period that you use it (Note; this may be capitalised to Inventory, for example, in certain scenarios). The asset should be amortised over its finite life in nearly all practical instances. Amortisation begins when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended.

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

What systems, processes and other practical requirements should I be thinking about?

So you're pretty sure that some of your internally generated costs meet the criteria to be capitalised, but how do you go about getting the systems and processes in place to record these internal costs?

Systems:

A popular way of recording time is through timesheets where the individual employees can book down to the hour the time spent on a particular project. This is important on a project basis because different projects may have different dates when they start being used. This means that although all time ultimately would be capitalised, it may start being used and so expensed through the income statement on a different date.

Processes:

Ideally you will have both preventative and detective controls that support your internally capitalised assets, for example:

Preventative – You need to have well communicated policies to employees in your business, responsible for creating new assets. Employees who are IT developers or scientists may have no knowledge of accounting standards and requirements.

Detective – There should be some review of the crucial elements of the balances that are capitalised. For example, a team manager should review their team's timesheets on a weekly basis to ensure that the right amount of time is being charged to the right projects.

It's a global world we live in - does the same apply worldwide?

The above perspectives reflect the Australian standards which are broadly aligned with the international standards, or the International Financial Reporting Standards. In many countries, these standards or an equivalent are required for domestic public companies.That said, certain countries have their own applicable standards, most notably, in the United States where they use US Generally Accepted Accounting Principles.

The main differences are as follows:

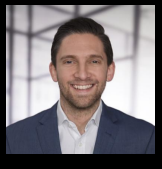
Research: Broadly speaking, research costs are treated in much the same way under the two accounting frameworks, with costs being expensed through the income statements.

Development: Differences arise where US guidance does not use the same broad-brush capitalisation criteria discussed above as the international standards and furthermore the timing of commencing capitalisation may differ. In general in the US, development costs are generally a lot harder to capitalize, meaning the same levels of complexity and judgement do not exist surrounding if the development criteria have been met under US standards. This results in situations where development costs are capitalised and amortized under the international standards but expensed upfront under US regulations.

In general the US standards are more prescriptive. In addition to the guidance in this research and development accounting standard above, there are specific requirements for motion picture films, website development, cloud computing costs and software development costs.

As always there is often judgement involved, so please reach out to your Tech Sector specialist.

Your PwC technology sector specialist contacts:



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