Introduction
Another Federal audit season has ended, and with its passing many Federal CFOs are faced with the inevitable stack of auditor findings, recommendations, and comments to correct in the short few months before audits, internal reviews, and inspections begin again. Among the most persistently challenging and significant of these findings for many agencies are those related to property, plant, and equipment (PP&E) and the most nebulous category of PP&E, Internal Use Software, or IUS. Federal agencies have experienced increasing success in solving auditability challenges for tangible real and personal property; however, the strategies employed for these types of property, such as sight-touch physical inventories, tagging and bar-coding, alternative valuation based on like-items in the marketplace, or broadly accepted parametrics, have often proven frustratingly ineffective or inappropriate for intangible software assets. While there is no silver bullet for effectively and consistently supporting management assertions for all IUS assets in the Federal environment, it is possible for Federal CFOs to attack auditability issues in a more manageable and realistic manner by understanding and working with some of the unique aspects of IUS and the associated accounting requirements. Federal CFOs should consider how defining and limiting populations for representation based on the Federal accounting standards and industry practice can focus remediation and reporting efforts and allow for faster and more efficient results.

Defining and limiting populations for representation
Properly defining capitalizable IUS and associated populations of potential assets for remediation and reporting is an important first step in addressing IUS auditability issues. The Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) 10: Accounting for Internal Use Software defines IUS as follows:

- Software used to operate an entity’s programs;
- Software used to produce the entity’s goods and to provide services; and
- Software that is developed or obtained for internal use and subsequently provided to other Federal entities with or without reimbursement.¹

As stated in SFFAS 10, IUS is classified as “general property, plant, and equipment” in accordance with SFFAS 6, Accounting for Property, Plant, and Equipment, and is further defined as software that is purchased from commercial vendors “off the shelf”, internally developed, or contractor developed solely to meet the entity’s internal or operational needs.²

Federal CFO Insights
Accounting for internal use software in the Federal environment
Tackling auditability challenges for Federal internal use software assets
Three important aspects of the FASAB definition of IUS may be leveraged to limit and further define populations of software applications which a Federal agency should consider when remediating auditability issues. These include software licenses and enhancements, capitalization thresholds, and useful life.

Software licenses
Software licenses are among the most numerous and common expenditures related to software applications for many Federal Agencies. Significantly, the FASAB excludes software licenses from its definition of IUS, specifying that it "would be appropriate for the federal entity to apply lease accounting concepts and the entity’s existing policy for capitalization thresholds and for bulk purchases to licenses. Immaterial costs would be expensed, but the entity should consider whether period costs would be distorted by expensing the license."

Based on this guidance, Federal CFOs may often exclude many small dollar value license fees paid for short-term (and especially single year) licenses when defining populations of applications for remediation and representation as IUS. However, Federal CFOs should carefully consider the overall annual expenditures for licenses to avoid distorting effects on the statement of net cost, and whether the terms of licenses may result in a classification as capital leases.

Software enhancements
Software applications and operating systems frequently undergo enhancements, upgrades, security patches, and routine maintenance releases to keep pace with the rapid evolution of technology and mission needs. The pace and volume of such changes can present a daunting challenge to tracking and accounting; however, when defining capitalizable enhancements, Federal CFOs should understand the requirements and determine that definitions are sufficiently narrow to avoid unnecessary efforts. SFFAS 10 states that the acquisition cost of enhancements to existing IUS (and modules thereof) should be capitalized when it is more likely than not that they will result in significant additional capabilities. In contrast to SFFAS 6, it is permissible to expense efforts that extend the useful life or increase the capacity of existing IUS assets when these upgrades do not introduce significant new functionality. Furthermore, minor enhancements resulting from on-going systems maintenance are to be expensed in the period incurred. Federal CFOs should consider appropriate policies and controls to define and identify enhancement efforts that introduce “significant” new capabilities to an IUS asset, such as specifying upgrades from an X.1 to X.2 version may be considered as not introducing significant new capabilities, whereas an upgrade from an X to a Y version may be considered significant. Business rules will vary, but should consider the guidance from SFFAS 10 highlighted above. Judgment is required in determining what is “significant” and such judgments should be based on observable evidence and fully documented.

Capitalization thresholds
Capitalization thresholds are critical to allowing Federal agencies to determine that financial reporting is materially accurate while balancing the costs associated with accumulating, analyzing and reporting transactions. Since software applications and improvements to software represent intangible and costs are often difficult to bifurcate or track separately where acquisitions are not significant, Federal Agencies have often established higher capitalization thresholds for IUS than for other categories of PP&E. FASAB recognized and supported this position in SFFAS 10 where it states that “software is more fluid and malleable than other PP&E and the Board concludes that a higher threshold for capitalization is reasonable.”

Due to the diversity in mission requirements, complexity, size, and stakeholder needs of each Federal agency, determining an appropriate capitalization threshold for IUS is a challenging topic to address. It is critical that leadership, and Federal CFOs in particular, analyze their agency’s operating environment and stakeholder needs, and leverage the flexibility and discretion afforded to them in setting a capitalization threshold that enables materially correct account balances while preventing the agency from exhausting excessive time, effort, and cost associated with capitalizing, tracking, and monitoring immaterial software projects.
Useful life
The useful life for most software applications is normally no more than five years due to the rapid pace of technological change in the software industry and the rate of obsolescence of underlying hardware and operating systems needed to run the applications. The Internal Revenue Service specifies a useful life of 36 months for software and many Federal agencies have established policies specifying useful lives for IUS assets, often for no more than five years. It is important to note however, that SFFAS 10 specifically requires that the useful life used for amortization should be consistent with that used for planning the software’s acquisition.7

Federal CFOs may use the prevailing useful life for common IUS to limit the universe of potential capitalized IUS that must be supported and reported for financial statement purposes. Often the financial records and transactions will be better maintained and accessible for more recent acquisitions, which may facilitate faster and more accurate analysis and reporting for these assets. For assets older than the prevailing useful life, the net book value would be zero dollars and the need to expend resources to identify and support such assets may not justify the cost.

Conclusion
By carefully considering how an agency defines IUS and important characteristics such as capitalization threshold, and useful life, Federal CFOs can limit and focus efforts to the most significant and supportable assets while reducing cost and effort expended on more marginal potential assets. Once the underlying definition is determined and documented, Federal CFOs may work with their systems administrator and CIO functions to determine the “universe” of all active software applications running on agency networks and workstations which meet aspects of the definition, essentially completing an electronic “inventory” of potential assets for further analysis and confirmation of reporting status and sufficiency of underlying documentation.

When it comes to audit readiness, accounting for PP&E, especially IUS, can be a challenging and complex undertaking. Although there is no “one size fits all” approach to appropriately account for costs associated with IUS assets, it is important that Federal CFOs take advantage of the provisions afforded to them through FASAB’s guidance to establish practices, policies, and capitalization thresholds that align to their unique operating environments and business needs while maintaining the flexibility necessary to successfully execute mission requirements.

References:
FASAB
• SFFAS #6 “Accounting for Property, Plant, and Equipment”
• SFFAS #10 “Accounting for Internal Use Software”
• Technical Release #5 “Implementation Guidance on SFFAS#10”

Endnotes
1. SFFAS 10, paragraph 7
2. SFFAS 10, paragraph 9
3. SFFAS 10, paragraph 67
4. SFFAS 10, paragraphs 25–27
5. SFFAS 10, paragraph 73
6. Internal Revenue Service Publication 946 How to Depreciate Property Chapter 1, page 10
7. SFFAS 10, paragraph 32
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