



## ACCOUNTING FOR CAPITALIZATION OF AGILE LABOR COSTS

by Pat Reed and Walt Wyckoff

***Objective: This document is intended to clarify and operationalize capitalization rules for Agile projects through defining an agile project accounting stage framework, with an agile interpretation on work and deliverables as outlined in SOP 98-1, ASC 350-40, FAS 886 and ASC 985. This document does not offer specific accounting advice, but represents a practical and viable Agile Accounting approach to capitalizing agile project costs that is in practice at a number of major US corporations. However, each organization is unique and company policies may differ. Please consult with your technical accountant, auditor or appropriate accounting professional to review your internal capitalization policies and processes for agile software development.***

Today's digital economy, pace of disruptive technology advancements and turbulent market conditions will continue to raise customer expectations for differentiating product and service experiences and challenge business adaptability. Regardless of your industry, software is becoming increasingly core to your business success and agile practices will be critical to deliver differentiating customer value and business agility. Your portfolios are likely to prioritize initiatives to develop innovative software assets, strengthen your enterprise software delivery engines and accelerate enterprise agile adoption. It's more important now than ever to understand how to accurately account for agile labor and agile capitalization in support of optimizing business performance.

Our world has changed significantly since the 1980's and 90's when internally developed software started to emerge from the shadows of the back office into increasingly critical operations and gain recognition as potentially significant assets. Inconsistencies in reporting and lack of accounting guidelines at that time prompted the US Securities and Exchange Commission (SEC) to require that GAAP (Generally Accepted Accounting Principles) be followed in order to eliminate these inconsistencies across companies and ensure investors made informed decisions. The Financial Accounting Standards Board (FASB) published guidance to ensure organizations appropriately define, standardize and report software development costs for internal use and software for sale. Naturally the guidelines were written in language consisted with the phased, waterfall based IT development model which was prevalent at that time.

Accurate and consistent accounting for capitalization of labor cost with an agile focus on value (asset) creation and reducing expense provides one of the most quantifiable and compelling benefits of practicing enterprise agility. However, as organizations adopt Agile development and delivery models, they need to interpret guidance (SOP 98-1, ASC 350-40 for internal use and FAS 86 ) through an agile lens and evolve outdated financial reporting and legacy accounting practices and policies. Some of the risks associated with not gaining this

practical Agile Accounting knowledge to consistently and appropriately account for corporate investments in software include:

- Loss of material benefits and positive impact on earnings and bottom line valuation possible with improved expense management through utilizing the Agile methodology (decreasing waste and the cost and risk of waterfall software development)
- Inconsistencies in interpretation of project cost accounting and defeating FASB's original intent of generating consistent accounting and reporting practices
- Adverse impact on team productivity, focus and morale if distracted by excessive time and expense tracking
- Over-expensing software development labor costs that should be capitalized
- Inappropriate audit findings and subsequent impact to financial reporting
- Limiting organizations and industry from fully adopting and leveraging the benefits of Agile Software Development throughout the enterprise

### Accounting for Agile Project Labor Costs

To understand the capitalization of agile development expenditures, we should return to the definition of an "asset" and "capitalization," and as well recall the spirit of ASC 350-40 and SOP 98-1. The three stages of an IT project outlined in SOP 98-1 for internal use software development can be applied to agile as well as waterfall-developed software projects. An asset is defined as a potential future economic benefit that the firm controls based on past transactions. To capitalize is to record an expenditure as an asset rather than to treat it as an expense of the current period. The following describes the three different stages referenced in SOP 98-1 for an agile-developed project:

1. The Preliminary Project Stage includes conceptual formulation, evaluation and final selection of alternatives. Generally, once technical feasibility and the business case analysis are completed, the project is ready for consideration for funding approval by a company representative with appropriate budget authority. After funding approval, the team participates in a kick-off, or project inception, to deepen their understanding of WHAT the customer needs and to ensure that they will deliver an economic benefit to the organization with a high-level release plan. All costs are expensed during this stage.
2. In the Application Development Stage, the design of the chosen path, including software configurations and interfaces, marks the capitalization of project labor costs. The team now moves from WHAT to HOW. All work associated with designing, developing, coding, testing and installing the asset are vital to the creation of valuable features for the customer and should be capitalized. The customer may be an internal department which will indirectly benefit the company's net cash flows in the future. Key exceptions in this stage that should be expenses are administrative overhead, training and manual data conversion.
3. The Post-Implementation / Operation Stage begins after the code is in production and after final customer acceptance, testing and stabilization are completed. Typical activities in this stage include training, bug-fixing and routine maintenance. The costs at this stage are expensed.

Additional Clarification re: Accounting for the Costs of Computer Software to be Sold, Leased or otherwise Marketed (FASB Statement 86 issued 8/85 and ASC 985-20  
<http://www.fasb.org/summary/stsum86.shtml>

The two relevant points on the timeline for software for sale or lease:

(A) The first clear bright line occurs when technological feasibility is established. It's important to align and document a working, consistent definition of technology feasibility: the clear bright line when the enterprise has completed necessary R&D work to establish that it is feasible to create a product re: specifications, functions, features and performance. Labor costs prior to this point in time (throughout the technological feasibility analysis) will be expensed. Labor costs after this point in time will be capitalized.

(B) The second bright line occurs when the product is available for general release to customers; after which time costs of maintenance and customer support should be charged to expense when related revenue is recognized or when the costs are incurred, whichever occurs first.

The impact of appropriately capitalizing software development expenditures can be significant, and has a number of important benefits re: competitive health of the company. It also ensures consistent reporting and capital allocation within and across organizations for investor confidence and compliance with GAAP. Applying an agile interpretation of guidance can optimize your focus on value creation and innovation and is one of the most quantifiable and compelling benefits of enterprise agility

#### Frequently Asked Questions:

#### **How to estimate and allocate costs on Agile Projects?**

Topic addressed explicitly in SOP 98-1, with the following guidance:

“Overhead costs associated with a particular internal-use software development project could be even more complex to measure than production overhead and, as they most often represent an allocation among capitalizable and expensed functions, may not be sufficiently reliable. Moreover, certain users commented that they believe that overhead costs had little relationship to the value of software. In light of such apparently high costs, modest benefits, and the view of some users that such costs should be expensed, AcSEC chose to analogize to advertising costs and FASB Statement No. 91 and to require such costs to be expensed as incurred.”

It's important to partner closely with technical accountants and finance partners to ensure whatever process and controls you develop are defensible, consistent and auditable and follow GAAP and International Financial Reporting Standard Principles:

#### GAAP

1. Objectivity principle: the company financial statements should be based on objective evidence.
2. Materiality principle: the significance of an item should be considered when it is reported.
3. Consistency principle: The company uses the same accounting principles and methods from year to year (note: referenced by documented policies)
4. Conservatism principle: when choosing between two solutions, the one that will be least likely to overstate assets and income should be picked

#### IFRSP

- Fundamental qualitative characteristics of financial information:
  - Relevance

- Faithful representation
- Enhancing qualitative characteristics include:
  - Comparability
  - Verifiability
  - Timeliness
  - Understandability

For more information about the Agile Alliance Agile Accounting Program, please contact: [agileaccountingstandards@agilealliance.org](mailto:agileaccountingstandards@agilealliance.org)

**Additional Reference Links you may find of interest:**

- SOP 98-1 [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176156442651&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176156442651&acceptedDisclaimer=true)
- FASB - Financial Accounting Standards Board: <http://www.fasb.org/st/>
- Catherine Connor's blog on Top 10 Pitfalls of Agile Capitalization: <https://www.rallydev.com/blog/agile/top-10-pitfalls-agile-capitalization>
- <http://www.slideshare.net/CAinc/agile-capitalizationfor-greater-business-value>
- Generally accepted accounting principles: [https://en.wikipedia.org/wiki/Generally\\_Accepted\\_Accounting\\_Principles\\_%28United\\_States%29#Assumptions](https://en.wikipedia.org/wiki/Generally_Accepted_Accounting_Principles_%28United_States%29#Assumptions)
  - [http://stevedenning.typepad.com/steve\\_denning/2010/09/how-do-you-explain-agile-or-radical-management-to-a-cfo-.html](http://stevedenning.typepad.com/steve_denning/2010/09/how-do-you-explain-agile-or-radical-management-to-a-cfo-.html)
  - <http://itprojectfinancials.com/insights/2011/06/05/capitalizing-software-development-costs-from-sdcl-to-agile/>
  - [http://web.stanford.edu/group/fms/fingate/staff/capitalequip/capital\\_software.html](http://web.stanford.edu/group/fms/fingate/staff/capitalequip/capital_software.html)
  - <http://rwu.edu/about/university-offices/finance/policies/internal-labor-capitalization-policy>
  - [http://www.proformative.com/questions/capitalizing-web-development-costs?pf\\_source=sj-accounting-for-software](http://www.proformative.com/questions/capitalizing-web-development-costs?pf_source=sj-accounting-for-software)
  - [http://www.intosaiitaudit.org/intoit\\_articles/27\\_p18top30.pdf](http://www.intosaiitaudit.org/intoit_articles/27_p18top30.pdf)
  - <http://www.accountingtools.com/standard-costing>
  - <http://www.gao.gov/new.items/d093sp.pdf>
  - <http://accounting-financial-tax.com/2009/05/capitalization-and-amortization-of-software-cost/>
  - <http://www.accountingtools.com/questions-and-answers/capitalization-of-software-development-costs.html>
  - <https://www.fdic.gov/oig/a-rep02/02-014-508.html>
  - <http://www.gao.gov/assets/220/210483.pdf>
  - <https://www.fdicig.gov/reports02/02-014.pdf>
  - <http://finance.duke.edu/accounting/gap/m200-075.php>
  - [https://en.wikipedia.org/wiki/Software\\_development\\_effort\\_estimation](https://en.wikipedia.org/wiki/Software_development_effort_estimation)
  - <http://www.infoq.com/articles/agile-capitalization>
  - <http://itprojectfinancials.com/insights/2011/06/05/capitalizing-software-development-costs-from-sdcl-to-agile/>
  - <http://www.informit.com/articles/article.aspx?p=169495&seqNum=2>
  - <http://ifrsclass.com/ifrs-index.htm>
  - [http://bayaln.org/meetings/20120717/SOP\\_98-1.pdf](http://bayaln.org/meetings/20120717/SOP_98-1.pdf)