OFFICE OF THE UNDER SECRETARY OF DEFENSE
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COMPTROLLER

SEP 30 2015

MEMORANDUM FOR ASSISTANT SECRETARIES OF THE MILITARY DEPARTMENTS
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES
DIRECTOR, JOINT STAFF

SUBJECT: Strategy for Internal Use Software Audit Readiness

This memorandum establishes policy guidelines for achieving audit readiness for Internal Use Software, including all management assertions (Existence, Completeness, Rights and Obligations, Presentation and Disclosure, Valuation) by September 30, 2016.

Attached is a detailed explanation of this strategy and guidance for its implementation. Appendices to the memorandum contain a decision tree, frequently asked questions, and definitions. Relevant provisions of this policy will be incorporated into future updates of applicable Department of Defense Financial Management Regulation chapters.

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Attachments:
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Deputy Chief Management Officer
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Department of Defense
Strategy for Internal Use Software Audit Readiness
September 2015

I. INTRODUCTION

Objective

The objective of this document is to provide a Department of Defense-wide Internal Use Software (IUS) audit readiness strategy that meets the following three criteria in descending order of importance:

1. Is compliant with Generally Accepted Accounting Principles (GAAP);

2. Is cost- and time-effective; and

3. Can be implemented consistently across the Department of Defense (the Department or DoD)

Background

Internal Use Software that meets the criteria for capitalization in accordance with GAAP must be reported on DoD financial statements within the General Property, Plant, and Equipment, Net line on the Balance Sheet and as IUS within Note 10 of the financial statements. The April 2015 Financial Improvement and Audit Readiness (FIAR) Guidance establishes IUS as a Mission Critical Asset category because it is likely to be material to the financial statements of many Components (Military Services and Defense Agencies) and the DoD Consolidated Financial Statements. This presents a risk to the Department's objective of reaching full financial statement audit readiness by September 30, 2017. The overall audit readiness strategy for IUS contains the following two initiatives:

1. Establishing systems, processes and procedures to implement Statement of Federal Financial Accounting Standards (SFFAS) No. 10 Accounting for Internal Use Software effective October 1, 2016; and

2. Establishing the processes, controls, and system capabilities to maintain the balance into the future with appropriate additions, disposals and other changes as they occur.

Applicable Accounting and Reporting Requirements/Guidance

At a meeting of the Federal Accounting Standards Advisory Board (FASAB) on August 27, 2015, the Board members agreed to a FASAB Staff recommendation to defer the implementation date of SFFAS 10 so that the requirement for capitalization of Internal Use Software will be applied on a prospective basis (as of October 1, 2016 for DoD). The FASAB Staff recommendation was made in response to a request from the DoD OUSD(C) FIAR Directorate to the Staff for this deferral. In order to become an authoritative pronouncement this decision by

the FASAB Board will need to follow the standard FASAB procedure of being published in an exposure draft for public comment prior to being memorialized in a Standard, Technical Bulletin or Technical Release. The guidance set out in this document is based on the premise that the verbal agreement of the FASAB Board members will ultimately be issued as an authoritative pronouncement, and that an exposure draft of a Technical Release referenced below will be finalized without substantial changes.

Current applicable accounting and reporting requirements/guidance for Internal Use Software, on which this policy memorandum is based, include:

- Statement of Federal Financial Accounting Concepts (SFFAC) No. 5, *Definition of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*
- Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*
- SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
- SFFAS No. 10, *Accounting for Internal Use Software*
- SFFAS No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment*
- SFFAS No. 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*
- Technical Release 5: *Implementation Guidance on Statement of Federal Financial Accounting Standards 10: Accounting for Internal Use Software*
- Technical Release 13: *Implementation Guide for Estimating the Historical Cost of General Property, Plant, and Equipment*
- Statement of Federal Financial Accounting Concepts 5: *Definitions of Elements and Basic Recognition Criteria for Accrual-Basis Financial Statements*
- DoD Financial Management Regulation 7000.14-R Volume 4
- April 2015 Financial Improvement and Audit Readiness (FIAR) Guidance
- Deputy Chief Financial Officer Memo, *Elimination of Military Equipment Definition, and Increase to Capitalization Thresholds for Property, Plant and Equipment,* September 20, 2013
- Federal Financial Accounting Technical Release Exposure Draft: *Implementation Guidance for Internal Use Software*

Scope

"Software" includes the application and operating system programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system or program. Most often, software is an integral part of an overall system(s) having interrelationships between software, hardware, personnel, procedures, controls, and data.
"Internal Use Software" is software that:

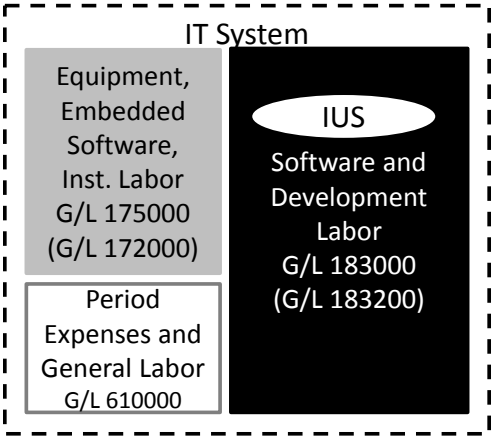


Figure 1: IUS is generally one component of an IT System

- Is acquired or developed to meet the entity's internal or operational needs *(intended purpose)*; and
- Is a stand-alone application, or the combined software components of an information technology (IT) system that can consist of multiple applications, modules, or other software components integrated and used to fulfill the entity's internal or operational needs *(software type).*

IUS can be purchased from commercial vendors "off-the-shelf" (COTS), modified "off the shelf," internally developed, or contractor developed. IUS includes software that is:

- Used to operate an entity's programs (e.g., financial and administrative software, including that used for project management),
- Used to produce the entity's goods and to provide services (e.g., maintenance work order management and loan servicing), and
- Developed or obtained for internal use and subsequently provided to other federal entities with or without reimbursement.

Internal Use Software does not include computer software that is integrated into and necessary to operate general Property, Plant, and Equipment (PP&E), rather than perform an application. This software shall be considered part of the PP&E of which it is an integral part and capitalized and depreciated accordingly (e.g., airport radar and computer operated lathes).

II. IUS AUDIT READINESS STRATEGY

A. Activities prior to October 1, 2016

DoD Components must evaluate any IUS already placed in service based on the criteria for capitalization:

- Useful life of two or more years;
- Intended for use by the entity;
- Not intended for sale in the normal course of business; and
- Total cost is greater than Component capitalization threshold.

The current Internal Use Software capitalization threshold for all DoD Components is $250,000, as outlined in the Deputy Chief Financial Officer Memo, Elimination of Military Equipment Definition, and Increase to Capitalization Thresholds for Property, Plant and Equipment, September 20, 2013. While future guidance may result in a change to the threshold level, all references in this guidance to capitalization threshold will apply regardless of the specific threshold in effect.

If the DoD Component has sufficient source documentation to support the IUS amount capitalized in accordance with SFFAS 10, they shall continue to apply the provisions of SFFAS

10 regarding amortization and impairment to any unamortized cost of the IUS. However, if the DoD Component does not have sufficient source documentation to support the IUS amount capitalized in accordance with SFFAS 10, they will write off the unsupported amount prior to October 1, 2016. This same approach will be followed for any additional IUS placed in service between the current date and October 1, 2016.

DoD Components must evaluate any IUS in development as of the current date that they have capitalized which meets the criteria for capitalization under SFFAS 10 (see Table 2). If the DoD Component has sufficient source documentation to support the IUS in development amount capitalized in accordance with SFFAS 10, they will continue to accumulate such costs until the IUS is placed in service or written-off due to impairment during the software development stage. Once the IUS is placed in service, the DoD Component must apply the provisions of SFFAS 10 regarding amortization and impairment to the accumulated amount. However, if the DoD Component does not have sufficient source documentation to support the IUS in development amount capitalized in accordance with SFFAS 10, they will write-off the unsupported amount prior to October 1, 2016. This same approach will be followed for any additional IUS in development costs incurred between the current date and October 1, 2016.

DoD Components must develop a plan to establish and/or enhance systems, processes and procedures to be fully compliant with accounting for IUS under SSFAS 10 by October 1, 2016. This includes documentation of the systems, internal controls, processes and procedures; such documentation will be required during an audit.

B. Activities on and after October 1, 2016

DoD Components shall capitalize IUS costs for IUS placed in service and IUS in development in accordance with the provisions of SFFAS 10. The DoD Components must have sufficient source documentation to support the capitalized amounts of IUS on the basis of actual historical cost. The DoD Components must apply the provisions of SFFAS 10 regarding amortization and impairment to any unamortized capitalized cost of the IUS.

The DoD Components shall also fully implement the systems, internal controls, processes and procedures to be compliant with accounting for IUS under SSFAS 10. They must also periodically review and update the documentation of the systems, processes and procedures as needed.

Three key updates to DoD policy will be implemented. a) Accountability requirements; b) The establishment of formal acquisition reviews; and, c) DoDI 5000.02, Federal Acquisition Regulations, and the Defense Federal Acquisition Regulation Supplement, and cost accounting policies will be amended to require that Contract Line Item Number (CLIN) structures for IUS acquisition map to the appropriate capital or expense United States Standard General Ledger (USSGL) accounts.

III. IUS FINANCIAL STATEMENT MANAGEMENT ASSERTIONS

There are five financial statement management assertions that must be addressed for financial reporting and audit readiness purposes, which are discussed briefly below. Further discussion of each assertion, as well as relevant risks, financial reporting objectives, and outcomes can be found in the April 2015 FIAR Guidance.

1. Existence

2015 FIAR Guidance 5.D.1.5.3: *Recorded Internal Use Software exists at a given date, is supported by appropriate detailed records that are accurately summarized and reconciled to the Accountable Property System of Record (APSR) and general ledger.*

A Component must be able to provide evidence that all reported IUS within its general ledger and on its financial statements exists. IUS differs from other mission critical asset types in that it is not tangible property, and can often be verified remotely through auto-discovery tools. Evidence of existence for in-service IUS could include installed executable binary computer files. Evidence of existence for in-development IUS could include executable binary files installed in test and development environments, installation media (such as DVDs or CDs) for software, design documents, electronic source code files, time sheets with time dedicated to specific software projects, or other artifacts that are typically produced during the software development lifecycle. Components must ensure that they have sufficient documentation and evidential matter to support the existence of IUS, and the documentation must be detailed enough to tie it to the specific IUS asset.

2. Completeness

2015 FIAR Guidance 5.D.1.5.3: *All Internal Use Software transactions are recorded (all direct and indirect cost have been recognized and recorded) within the Accountable Property System of Record (APSR) and general ledger.*

Completeness is a significant risk area for IUS. Much of the Department has never conducted the equivalent of a wall-to-wall physical inventory, nor has the definition of what constitutes IUS been consistently applied. As a result, many Components lack a detailed listing of IUS in the form of an APSR comparable to listings of other mission critical asset types as required by the FIAR Guidance. Establishing this detailed listing as of October 1, 2016 and maintaining that detailed listing thereafter are required to ensure completeness, and will be required for long term sustainment (See Accountability Requirements for IUS in Section V). The detailed listing as of October 1, 2016 may contain zero IUS assets for those Components who have not historically capitalized IUS costs prior to that date, or have written off previously capitalized costs in accordance with Section II A.1 and/or A.2 above.

Completeness of Bulk Purchase Software Licenses:

The Department's current policy of expensing all bulk purchase software and software licenses could create a material misstatement. The determination of whether an item is material depends

on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement (SFFAS 35 ¶5). The determination includes the consideration of whether period costs would be distorted or asset values understated by expensing the purchase of numerous copies of a software application or numerous components of a software system and, if so, provides that the collective cost shall be capitalized. Bulk purchases of software acquired on or after October 1, 2016 where the aggregate purchase amount meets or exceeds the capitalization threshold need to be capitalized as IUS.

Software licenses can vary in length. Term software licenses are defined as software licenses for which the license holder is only entitled to use the software for a specified time period, after which the right to use the software expires and the license must be renewed or a new license purchased in order to continue using the software. Perpetual software licenses are defined as software licenses that give the Department the right to use the software in perpetuity. As such, bulk purchases of IUS that are for terms less than two years in length do not need to be considered for capitalization.

3. Rights

2015 FIAR Guidance 5.D.1.5.3: *The reporting entity has rights to the recorded Internal Use Software at a given date.*

Control over access to the economic benefits conveyed by the IUS is the primary principle for determining financial reporting rights. Components will use the following two criteria to determine financial reporting responsibilities:

1. Exclusive Use – When a Component is the exclusive user of capitalized IUS, it will report the IUS on its balance sheet because it is receiving the economic benefit. If there is no exclusive user, proceed to the second criteria.

2. Control – If an exclusive user does not exist, the Component that controls the IUS will have financial reporting responsibility. Evidence of control can include funding the software's maintenance, exercising access control, and prioritizing enhancements. Having unlimited rights to software source code is not a necessary criterion to establish financial reporting rights.

While this is consistent with the Department's treatment for equipment and real property, IUS also has some unique characteristics that warrant additional discussion.

Licenses: Licenses convey varying degrees of rights to the Department. Lease accounting concepts, which are expressed as capital lease criteria, shall be applied to licenses for IUS to determine whether they are to be capitalized (SFFAS 10 ¶67). Further discussion of lease accounting concepts are included in Section IV.

Cloud and Other Subscription Based Services: When a Component pays regular subscription fees to access and use software that is funded, maintained, and owned by a non-DoD entity, the

subscription costs are to be expensed in the period incurred. This scenario is a service and does not constitute an IUS asset for the Department.

A cloud or subscription arrangement with a non-DoD entity can result in DoD-owned IUS if the using Component takes possession, or has the ability to take possession of a software application without incurring a significant penalty. This IUS shall be capitalized if it meets the capitalization criteria.

When a cloud or subscription arrangement exists between DoD Components, the Component that owns the software (see Rights) will report it as IUS. The subscribing Component(s) will expense any fees paid for the service in the period incurred.

4. Presentation and Disclosure

2015 FIAR Guidance 5.D.1.5.3: *All Internal Use Software is properly classified and summarized*

Information technology systems can include both hardware and software. Likewise, not all software is IUS. It is important that costs are correctly classified in the financial statement notes. For example, both IUS and equipment are included in the PP&E line of the balance sheet. However, they are summarized separately in Note 10 of the financial statements.
In addition, IUS must be placed in service at the correct time to begin amortization. IUS is considered placed into service when testing is completed. Internal Use Software in development that meets capitalization criteria but has not been placed into service (see Placed in Service Dates in Section IV) is recorded in USSGL Account 183200 – Internal Use Software in Development.

5. Valuation

2015 FIAR Guidance 5.D.1.5.3: *Internal Use Software transactions (all purchases, impairments, and development costs) are recorded at correct amounts, and Internal Use Software is valued on an appropriate valuation basis.*

The valuation of IUS is another significant risk area for the Department. A GAAP-compliant historical cost value will be accomplished through improved processes and controls, particularly within the acquisition process and through improved program cost accounting (i.e., SFFAS 10 approach). These improved processes and controls must be in place by October 1, 2016.

Placed in Service Dates

Placed in service dates need to be documented for both acquired IUS and developed IUS. Documented placed in service dates are critical in determining when to start amortization of capitalized IUS costs.

Valuation of Bulk Purchase Licenses

The Department's current policy of expensing all bulk purchase software could create a material misstatement. Software licenses can be term or perpetual. Term licenses provide the right to use the software for a specified period of time. Perpetual software licenses give the Department the right to use the software in perpetuity. As such, bulk purchases of IUS with terms less than two years in length do not need to be considered for capitalization.

Table 1: Capitalization is dependent on term and aggregate purchase amount

Bulk Purchased License Terms	Aggregate Purchase Amount	Guidance
License Term < 2 years	N/A	Expense
License Term = / > 2 years or Perpetual	Under capitalization threshold	Expense
License Term = / > 2 years or Perpetual	Equal to or exceeding capitalization threshold*	Capitalize

*Maintenance agreements included in the purchase of licenses are not to be considered part of the historical cost.

IV. ACCOUNTING FOR IUS

Accounting for IUS includes the initial capitalization and subsequent accounting for amortization, disposals, enhancements and impairments of those capitalized amounts.

Capital vs. Expense IUS Activities

Many IUS programs and contracts include a variety of activities that are conducted by government and/or contractor personnel throughout the software development lifecycle. Some costs associated with these activities shall be capitalized as part of the cost of the IUS and some costs shall be expensed. Regardless of the development lifecycle (e.g., waterfall, agile, spiral, etc.), the capitalization decisions follow the activity. When reviewing contracts and budget documentation, care must be taken to distinguish between activities that are to be capitalized and those that are to be expensed.

Table 2: Capital vs. Expense IUS Activities (Adapted from SFFAS 10 ¶11)

Project Phase	Task	Treatment
Conceptual Planning/ Planning & Requirements	Project Evaluation	Expense
	Concept testing	Expense
	Evaluation of alternatives	Expense
	Project approval	Expense
Design/ Development & Testing/ Implementation	Design	Capitalize
	Coding	Capitalize
	Installation to Hardware	Capitalize
	Project personnel costs	Capitalize
	Testing	Capitalize
	Quality assurance testing	Capitalize
	Documentation	Capitalize
	General & admin costs	Allocate*
	Data conversion software	Expense
Operations & Maintenance/ Disposition	Training	Expense
	Data conversion	Expense
	Help desk	Expense
	Enhancement	See "IUS Enhancements" section
	Maintenance/Bug Fix	Expense

***** Appropriate indirect costs shall be allocated to IUS acquisitions to determine the full historical cost (SFFAS 10 ¶16) and the allocation methodology must be documented. The Acquisition, Technology, and Logistics (AT&L); Property and Equipment Policy Office is currently undergoing a study regarding the allocation of indirect program costs. The results of the study may impact future guidance regarding the allocation of indirect costs.

Software in Development

Costs related to capitalized activities identified in Table 1 shall be accumulated in General Ledger Account Number 183200 (Internal Use Software in Development) when the development activities last longer than a single reporting period. Costs are accumulated in the Internal Use Software in Development account but are not amortized until the software is placed into service. Costs shall begin accumulating in this account if the IUS is anticipated to meet capital criteria and the following two statements are true (SFFAS 10 ¶16).

1. Management authorizes and commits to the project and believes that it is more likely than not that the project will be completed and used to perform its intended function; and

2. The preliminary design phase is complete (i.e., conceptual formulation, design, and testing of possible software project alternatives) as evidenced by a documented approval decision.

Accumulated costs shall be transferred to General Ledger Account Number 183000 (Internal Use Software) when the IUS is placed into service (see Placed In Service Dates in Section IV). Many larger and more complex software systems, such as Enterprise Resource Planning systems, are developed and placed into service over time. For each module or component of a software project, costs shall be moved from USSGL Account 1832000 (Internal Use Software in Development) to USSGL Account 1830000 (Internal Use Software), and amortization shall begin when a module or component has been successfully tested. If the use of a module is dependent on the completion of another module(s), the movement from 183200 to 183000 will take place and amortization will begin when both that module and the other module(s) have successfully completed testing.

Placed In Service Dates

IUS is considered placed into service when final acceptance testing is completed (SFFAS 10 ¶41). The point at which this milestone is reached can vary for different types of software acquisitions.

For IUS acquired through a Major Automated Information System (MAIS) acquisition program, the Full Deployment Decision (FDD) date made by the Milestone Decision Authority (MDA) will serve as the placed in service date.

For other IUS system acquisitions, the Initial Operational Capability (IOC) date will be used as the placed in service date. The IOC is often defined in the system's Capability Development Document (CDD) and/or Capability Production Document (CPD). For acquisitions that do not require a CDD or CPD, other supporting documents can be used as appropriate.

For each module or component of a software project, amortization begins when a module or component has been successfully tested. If the use of a module is dependent upon completion of another module(s), the amortization of that module begins when both that module and the other module(s) have successfully completed testing. Specifically, if the module provides economic benefit through distinct and substantive functionality, and meets the Component's capitalization criteria, then the module can be treated as a separate IUS asset.

If knowledgeable parties within a Component determine that a placed in service date other than one listed above better aligns to the completion of final acceptance testing for a specific software acquisition, the alternate placed in service date can be used. However, the decision must be justified and documented.

IUS Enhancements

An enhancement is a modification to existing IUS that provides it with additional capabilities and enables the software to perform tasks that it was previously incapable of performing. An enhancement that increases the capability of the IUS shall be capitalized when its cost meets or exceeds the capitalization threshold. Criteria to capitalize enhancements to IUS differs from that of other PP&E in that changes that merely extend the useful life or improve efficiency are to be expensed (SFFAS 10 ¶73).

Components shall begin accumulating costs for enhancements when it is determined that it is more likely than not that the enhancement will result in new capabilities (SFFAS 10 ¶25). When the development of the enhancement takes place over multiple periods, the costs will accumulate in USSGL Account 183200 (Internal Use Software in Development) until the enhancement is completed (see section on Placed in Service Dates above), at which time the costs are moved to USSGL Account 183000 (Internal Use Software).

Components must record enhancements in a manner that allows them to specifically identify and support each capitalized enhancement made to the asset.

If the enhancement impacts the useful life of the software, the remaining life will be extended an appropriate amount, but not more than 5 years. The amount of the extension can be determined through discussions with knowledgeable personnel and must be documented.

The cost of minor upgrades resulting from ongoing systems maintenance or incurred solely to repair a design flaw without adding additional capabilities shall be expensed in the period incurred. However, in instances where the useful life of the software is extended, the amortization period must be adjusted (SFFAS 10 ¶26-27).

Documentation related to IUS enhancement decisions, such as the justification for capitalizing the enhancement, a change of useful life, and the amount capitalized must be retained. Specific documents that support these decisions can vary by organization and asset, but could include an analysis from software developers or a cross-functional review team that defines the enhancement's impact on functionality and useful life.

IUS Impairment (SFFAS 10 ¶ 28-30)

Impairment shall be recognized and measured when one of the following occurs and is related to post-implementation/operational software:

- The software is no longer expected to provide substantive service potential (see Useful Lives below) and will be removed from service; or

- A significant reduction occurs in the software's or software module's capabilities, functions, or uses.

If the impaired software is to remain in use, the loss due to impairment shall be measured as the difference between the book value and either (1) the cost to acquire software that would perform similar remaining functions (i.e., the unimpaired functions) or, if that is not feasible, (2) the portion of book value attributable to the remaining functional elements of the software. The loss shall be recognized upon impairment, and the book value of the asset reduced accordingly. If neither (1) nor (2) above can be determined, the Component can continue to amortize the book value over the remaining useful life of the software. However, this decision and associated analyses must be documented and retained.

If the impaired software is to be removed from use, the loss due to impairment will be measured as the difference between the book value and the net realizable value (NRV), if any. The loss must be recognized upon impairment, and the book value of the asset reduced accordingly. The NRV, if any, shall be transferred to an appropriate asset account until such time as the software is disposed of and the amount is realized.

When a software project still in development is suspended pending management's evaluation on whether to resume or terminate the project, the software development cost may remain capitalized as long as a reasonable chance exists that the software project will eventually be completed and the cost incurred meets the capitalization threshold. The status of the project shall be reevaluated periodically and the capitalized cost written off as an incomplete software project if management concludes that it is more likely than not that the software will not be placed into service in the future.

When it is more likely than not that a software project will not be completed, no further costs are to be capitalized and any costs that have been capitalized shall be written off in accordance with SFFAS 10, paragraph 31. Indications that the software may no longer be completed include:

- The expenditures are neither budgeted nor incurred to fund further development;
- The discontinuance of the business segment for which the software was designed;
- The inability to resolve programming difficulties timely;
- Significant cost overruns; or
- A decision to obtain COTS instead and abandon the current software development.

Useful Lives

The Department applies useful lives of 2, 3, 4, 5, or 10 years to capitalized IUS (Department of Defense Financial Management Regulation (DoD FMR) Volume 4). The useful life will be determined during the planning phase of the asset's development based on the length of time it is expected to have economic benefit or service potential to the Component (SFFAC 5 ¶26). The decision shall be documented and will be made with the input from personnel familiar with the software's technical characteristics and its planned use. The useful life for licenses is the term of the license agreement, except for perpetual licenses, which shall be assigned a useful life of 5 years.

Bulk Purchases

Bulk purchases must be considered if they may materially affect the fiscal year financial statements in which they were purchased. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement (SFFAS 35 ¶5). To ensure that the

statements are not materially affected, new bulk purchases of software with an aggregate cost that exceeds the capitalization threshold shall be capitalized.

An exception to this requirement includes license agreements that do not meet the criteria established for capital leases in the Licenses section below. Costs related to such purchases shall be expensed in the period incurred.

When multiple acquisitions are made as part of a single contract within a fiscal year, the purchases shall be added together to determine whether they meet the capitalization threshold. Purchases made on a single contract during separate fiscal years are to be considered separately. Components must not split bulk purchases into multiple transactions with the intent of avoiding capitalization.

Licenses

License agreements to use software come in many forms. The determination of whether licensed IUS will be capitalized or not shall be based on lease accounting concepts in which several criteria are applied to determine whether a lease (or license) is to be capitalized (SFFAS 10 ¶67).

If one of the following criteria apply, the IUS can be expensed and the lease criteria analysis does not need to be conducted.

- The license term is less than two years;
- The license cost (excluding any maintenance agreements) is less than the capitalization threshold; or
- The aggregate cost of a bulk license purchase (excluding any maintenance agreements) is less than the capitalization threshold.

If none of the criteria listed above is applicable, the capital lease criteria described below must be applied. If any one or more of the following criteria apply, the IUS shall be recorded as a capital lease (SFFAS 6 ¶20).

Additional guidance regarding accounting for license agreements includes:

- Maintenance costs agreed to as part of the initial license agreement are to be expensed;
- "True-up" costs associated with unlimited license agreements or enterprise licenses that may occur (depending on the agreement terms) at the end of each year to reconcile and account for the actual quantity of users will also be expensed; and
- Software upgrades that are included in annual maintenance and security assurance agreements will not be capitalized as enhancements or separate assets.

Table 3: Capital Lease Criteria as Applied to Licenses

Criteria	Comment
The license transfers ownership of the property to the licensee by the end of the license term.	For IUS, this would mean that the license transfers ownership of the intellectual property (e.g., source code) to the licensee by the end of the license term.
The license contains an option to purchase the software at a bargain price.	For IUS, this would mean that license contains an option to purchase the software intellectual property (e.g., source code) at a bargain price.
The present value of minimum license payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the software.*	It is very unusual for software to meet this criteria. The value of the software itself typically far outweighs a license to use a copy of it.
The license term is equal to or greater than 75 percent of the estimated economic life of the software.*	Some licenses may meet this criteria. Economic life is defined as the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term. For example, a perpetual license will always be equal or greater than 75 percent of the estimated economic life. A license term of 5 years for software that has an economic life of 10 years would not meet this criteria.

*The last two criteria are not applicable when the beginning of the license term falls within the last 25 percent of the total estimated economic life of the software.

V. ADDITIONAL POLICY CHANGES FOR SUSTAINMENT

Sustaining the IUS balance in a manner that is effective and efficient will also require several fundamental changes to the way the Department acquires, manages, and reports IUS.

Accountability Requirements for IUS

Accountable records for capitalized and non-capitalized IUS will be required to support long term sustainment. APSRs form a foundation for asset accountability and auditable financial reporting. The Office of the Under Secretary of Defense (Acquisition, Technology, & Logistics) will develop and issue accountability requirements for IUS with input from DoD CIO and OUSD(C) FIAR. The specifics regarding the scope, criteria, and implementation timeline of this requirement are still under development, but it will be critical that APSRs reconcile with Component general ledgers and financial statements.

Changes to Acquisition Processes

The most costly IUS is often acquired as part of Major Automated Information Systems programs. These programs frequently do not differentiate between capital and expense costs. Acquisition requirements will be updated to align Contract Line Item Numbers (CLINs) and Accounting Classification Reference Numbers to the capital and expense activities displayed in Table 2.

Additionally, future reporting requirements will also include activity codes that align labor activities to capitalized IUS activities displayed in Table 2.

The effective dates of these requirements are still being determined. Once finalized, these requirements will be implemented prospectively so that existing contracts do not need to be modified.

Cross-Functional IUS Reviews

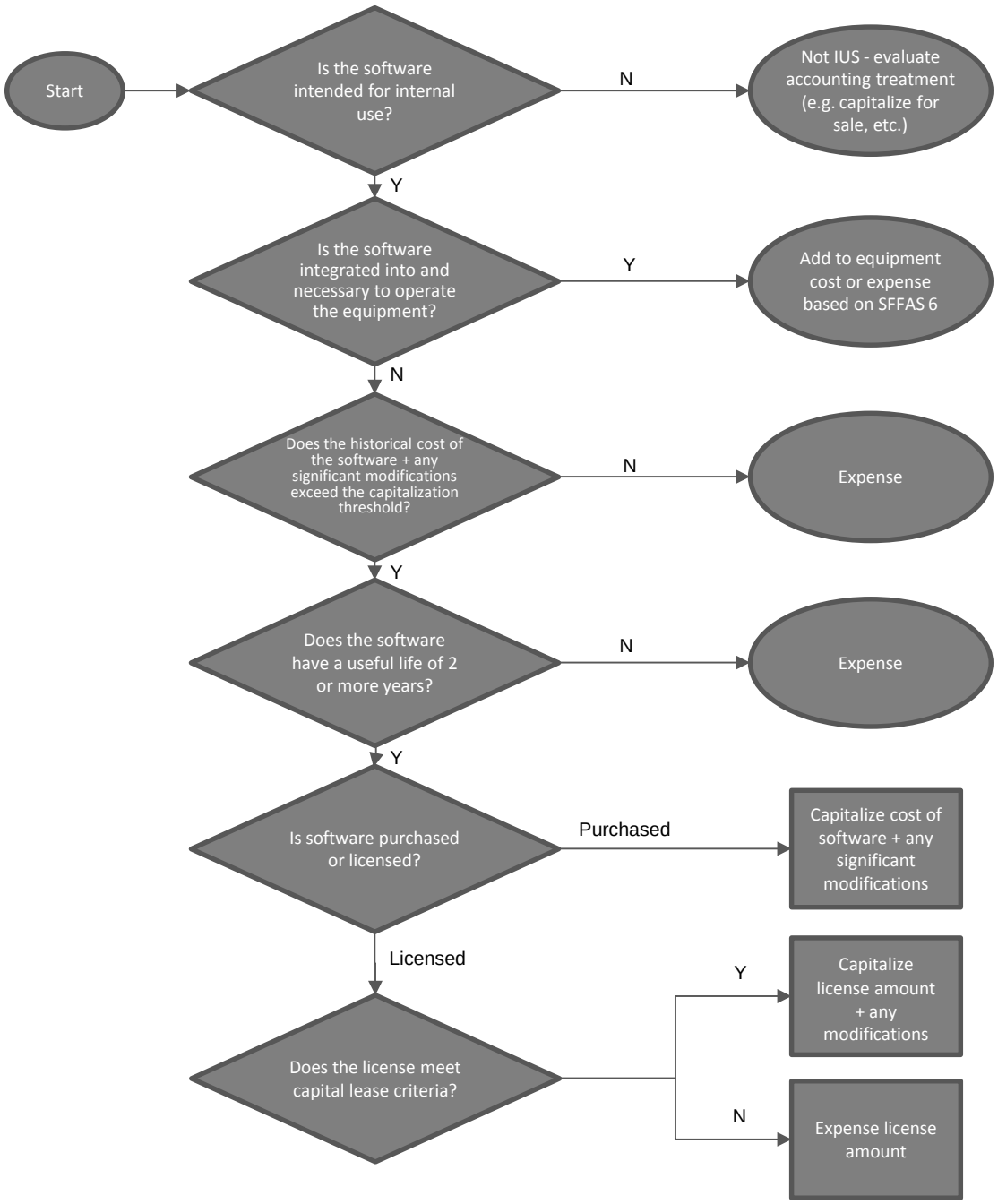
Software development can be complex and accounting decisions often require a measure of judgment and expertise found throughout an organization. Examples of these decisions can include identifying assets that meet the IUS definition, determining the point at which an IUS project is more likely than not to be completed, whether an enhancement should be capitalized, and determining the useful life. Components will ensure that key stakeholders from the IUS program, acquisition, and accounting organizations have adequate visibility into the major milestones throughout the acquisition process to make these decisions. This could take the form of an IUS acquisition review board, consisting of knowledgeable stakeholders who assess pending and active IUS projects to make such decisions. It could also include leveraging portfolio management processes already in place at some Components. Stakeholders will meet periodically and with enough frequency to make timely decisions concerning the IUS and the decisions will be documented. Additional cross-functional decisions and deadlines for making them are found in Table 4 below. This review activity can also serve as a key control.

Table 4: Cross-Functional Review Decisions and Timeline

Decision	**Decision Timeline**
Identify potential IUS	During the budget process and not later than end of planning phase
Determine that it is more likely than not that the IUS project will be completed	Prior to the completion of the planning phase
Assign a useful life	Prior to the end of final acceptance testing
Confirm that cost has been correctly accumulated and assigned to the asset	Prior to the end of final acceptance testing
Confirm that indirect costs have been appropriately allocated	Prior to the end of final acceptance testing
Assign an in-service date	Prior to the end of final acceptance testing
Determine if licenses meet capital lease criteria	Upon license agreement execution
Identify potential capital enhancements	During the budget process and not later than end of planning phase
Management Oversight Decisions • Impairment • Evaluation of suspended projects o More likely than not that the project will be completed o More likely than not that the project will be cancelled	On-going

Appendix A: IUS Capitalization Decision Tree

The following illustration provides a basic decision making process for the capitalization of IUS assets. Additional detail may be required when making accounting decisions involving more nuanced issues. In these cases, the DoD FMR Volume 4 must be consulted.



Appendix B: Frequently Asked Questions

This Appendix contains a sample of the frequently asked questions for implementation of the DoD Financial Statement Reporting for Real Property Policy. Additional frequently asked questions will be posted on the OUSD (Comptroller) website as they are encountered.

Question 1: *Is a software application that is used solely for internal purposes but does not meet the criteria to be capitalized IUS?*

Response 1: Yes. IUS is a category of software defined by its type (standalone applications and software components of systems) and purpose (internal use). The determination of whether the IUS will be capitalized or expensed pertains to the proper accounting treatment for the IUS. The audit readiness strategy described in this document focuses primarily on capitalized IUS. However, additional requirements for sustainment are currently being developed (see Section V).

Question 2: *What Component has financial reporting rights to an IUS asset that is funded and maintained by a Component that does not use it for internal purposes, but the IUS is used by other DoD Components that do not control, fund, or maintain the IUS?*

Response 2: To have financial reporting rights (responsibility) for an asset, the Component must receive economic benefits (or service) from the asset and control access to the asset's economic benefits. This scenario presents an unusual case where one Component controls the asset but receives no benefit and multiple other Components receive benefits but do not have control. Based on the approach set forth in Section III, financial reporting responsibility can be determined using the two tier criteria:

1. Exclusive Use – When a Component is the exclusive user of capitalized IUS, it will report the IUS on its balance sheet. If there is no exclusive user, proceed to the second criteria.

2. Control - If an exclusive user does not exist, the Component that controls the IUS will have financial reporting responsibility. Evidence of control can include funding the software maintenance, exercising access control, and prioritizing enhancements.

In the above scenario there is no exclusive user. Therefore, financial reporting responsibility falls to the controlling Component, which funds, maintains, and controls the IUS. The using Components will expense fees paid to use the IUS asset in the period in which they are incurred. A Memorandum of Understanding (MOU) or Memorandum of Agreement (MOA) must also be established between Components in scenarios such as this one.

Question 3: *Should cloud computing services be reported as IUS?*

Response 3: Cloud services can take a number of forms. To determine whether the arrangement includes capitalized IUS, the Component will need to examine the nature of the arrangement and apply their capitalization criteria. Many cloud arrangements are essentially Software-as-a-Service, where Components run applications from a cloud service provider on a subscription

basis, with no software license, and with little or no operational control over the software. This type of arrangement will be expensed as a service. However, if a cloud arrangement allows a Component to take possession, or have the ability to take possession of a software application without incurring a significant penalty (e.g., Infrastructure as a Service), the IUS software can be capitalized if it meets the capitalization criteria.

Question 4: *Is Microsoft Office IUS?*

Response 4: Yes. Microsoft Office is licensed application software that is used for internal operations. However, it is unlikely that Microsoft Office would meet capitalization criteria unless it:

1. Is purchased in bulk in an aggregate amount equal to or exceeding the capitalization threshold defined in the September 2013 policy memo; and

2. Meets the capital lease criteria set forth in Section IV.

Question 5: *Is an Enterprise Resource Planning (ERP) system IUS?*

Response 5: An ERP system will generally contain capitalized IUS, but the system as a whole will also encompass costs and assets, such as hardware, that are not IUS (see Figure 1). To identify the portion(s) of an ERP that are to be capitalized as IUS, Components shall apply three tests:

1. Does it meet the definition of IUS? (Section I);

2. Does it meet the capitalization criteria (costs should be considered in aggregate)? (see Appendix A – Decision Tree); and

3. What activities and costs are to be capitalized? (see Table 2).

The portion of ERPs that are to be capitalized as IUS can be recorded with each individual component as a separate record or as a single record composed of multiple applications or modules that are integrated into a single system. If each IUS component is recorded separately, their aggregate value will still be the basis of capitalization decisions.

Question 6: *Should subscription fees paid to use software as a service be capitalized as IUS?*

Response 6: No. Subscription costs are expensed in the period in which they are incurred.

Question 7: *Should maintenance agreements purchased with a software license be considered part of the software's cost when determining whether the IUS should be capitalized?*

Response 7: No. Maintenance costs are not included in the historical cost of IUS when determining whether it is to be capitalized. If maintenance costs are not distinguishable from the cost of the license itself, reasonable and documented estimating methods can be used.

Question 8: *Are licenses for software used exclusively in a development or test environment rather than a production environment considered IUS?*

Response 8: Yes. These assets are IUS. However, they will only be capitalized if they meet capitalization criteria.

Question 9: *Does each software asset in development need a separate software in development account?*

Response 9: There is no GAAP requirement to establish a separate account for each software asset under development. However, Components may elect to create separate subaccounts to USSGL 1832000 (Internal Use Software in Development) to better differentiate and track costs.

Question 10: *How should IUS be accounted for if it is developed through a joint venture between two or more organizations, including at least one organization outside of the Department of Defense?*

Response 10: The DoD Component must capitalize the IUS asset if it meets the criteria for capitalization, based on its portion of the development cost in relation to the capitalization threshold. The Component will only record the costs for the portion that it funded.

Question 11: *Can existence be evidenced by utilizing auto-discovery tools?*

Response 11: Yes. Utilizing an auto-discovery tool will satisfy existence requirements. An inventory report as of a particular date or a screen shot from an auto-discovery tool would provide evidence that the asset exists similar to the hands-on approach utilized for tangible assets. It is important that the evidence produced be detailed enough to tie it to the asset's APSR record.

Question 12: *How should Components account for per-seat licenses, in which the cost is dependent on the number of users that have access to the software?*

Response 12: Components will follow bulk purchase guidelines included in this document.

Question 13: *If an IUS asset goes through a modification that costs more than the capitalization threshold to correct a design flaw and in effect doubles its useful life, should the modification be categorized as an enhancement and capitalized?*

Response 13: No, if the modification does not add any new capabilities to the software, the cost will be expensed in the period incurred. However, the useful life of the IUS asset will be adjusted to reflect the modification. The additional useful life shall be determined by knowledgeable personnel and will not exceed 5 years added to the existing useful life.

Question 14: *If a Component has deployed a "test" application which is being used in a field testing capacity but not formally placed into service, would that application be considered part of the population used to satisfy the completeness portion of FIAR requirements?*

Response 14: Yes**.** An application deployed to the field in a testing capacity before having gone through final acceptance testing, would not be considered placed into service and therefore would not be accounted for as IUS. However, costs related to the application would continue to accumulate in the Internal Use Software in Development account (GL Account 183200) and would therefore be included for completeness of the Internal Use Software in Development.

Question 15: *Is operating system (OS) software considered IUS or is it integrated/embedded software to be accounted for as part of equipment?*

Response 15: Computer hardware requires OS software in order to operate, making it integrated/embedded software (see Section I Scope). An example of this scenario is Microsoft Windows installed on desktop and laptop computers. The cost of the computer includes the OS software.

Question 16: *How should obsolete IUS be treated?*

Response 16: If the obsolete IUS will no longer be used it can be written off. If the IUS may continue to be used, the accounting treatment is dependent on several factors:

1. The acquisition cost of the IUS: If the acquisition cost was below the capitalization threshold it may be recorded for accountability purposes but no further accounting entries need to be made; and

2. Remaining net book value (NBV): If the obsolescence affects the remaining useful life, impairment needs to be evaluated and calculated (see Section IV).

Question 17: *How should software that is developed on behalf of another DoD agency be accounted for?*

Response 17: While in development, capitalizable costs as defined in Table 2 must be recorded in the Internal Use Software in Development account (USSGL 183200) of the Component funding the development. When the IUS is placed into service, the IUS will be recorded in the Internal Use Software account (USSGL 183000) of the Component with rights to the IUS (see Section III Rights).

Question 18: *Can software that is installed on equipment after the equipment is deployed, and provides the equipment with additional capabilities separate and apart from its core functionality be considered IUS?*

Response 18: Differentiating between software that is IUS and software that is considered "integrated" based on SFFAS 10 paragraph 22 is not always black and white. Software that operates the equipment is embedded software will be capitalized as part of the equipment cost. However, software used in conjunction with the operation of equipment can be considered IUS if all of the following criteria apply:

1. The software was developed separately from the equipment;

2. The software is not required for the equipment to perform its core purpose and functions; and

3. The quantity of equipment items on which the software will be installed is unknown.

Question 19: *What is the accounting treatment of an unlimited license agreement / enterprise license agreement?*

Response 19: The specifics of each license can vary. Assuming it is a perpetual license for software that meets the IUS definition and the initial license cost exceeds the capitalization threshold, the license cost shall be capitalized as IUS and amortized over 5 years. Any maintenance costs agreed to as part of the initial agreement are to be expensed. Any "true-up" costs that may occur (depending on the agreement terms) at the end of each year to reconcile and account for the actual quantity of users is also expensed. Upgrades that are included in annual maintenance and security assurance agreements will not be capitalized as enhancements or separate assets.

Question 20: *How should costs be accounted for from a financial statement reporting perspective in the following hypothetical scenario:*

- *A DoD Component has IUS in development spanning a period of time from September 2013 to September 2017;*

- *The development is completed and the IUS is placed in service in October 2017;*

- *Sufficient source supporting documentation for development costs does not exist until October 1, 2016; and*

- *In this scenario, the development costs incurred from September 2013 to September 2016 total $300,000; and, the costs incurred between October 2016 to September 2017 total $275,000.*

Response 20: Based on the hypothetical scenario, the IUS development costs incurred from September 2013 through September 2016 should be expensed because there is not sufficient source documentation to support their capitalization as IUS in development. The costs incurred from October 2016 to September 2017 should be capitalized as IUS in development in USSGL Account 183200 because they have sufficient supporting source documentation and exceed the capitalization threshold. Once the IUS is placed in Service in October 2017 these capitalized costs of $275,000 would be transferred to the IUS USSGL Account 183000.

Question 21: *If software is Common Access Card (CaC) enabled, does that indicate that it is IUS?*

Response 21: Whether the software is CaC enabled or not has no bearing on whether it is IUS.

Appendix C: Definitions and Examples

The following table contains common terms and scenarios relevant to IUS.

Definition	IUS	Capitalization	DoD Examples*
Access Control Software			
This type of software, which is external to the operating system, provides a means of specifying who has access to a system and the specific capabilities authorized users are granted.	No	Include with equipment costs	CA-ACF2, RACF, CA-Top Secret
Application Software			
A software program that performs a specific function directly for a user and can be executed without access to system control, monitoring, or administrative privileges.	Yes	Yes - When capitalization criteria is met	Microsoft Excel, Adobe Photoshop
Cloud – Public			
A cloud based environment that is generally external to the Department with infrastructure owned and managed by a third party. Public cloud services are generally subscription based.	No	No	Dropbox
Cloud – Private			
A cloud based environment that is generally internal to the Department and used solely by DoD Components.	Yes	Yes – The DoD Component that controls the IUS has financial reporting responsibility	DISA milCloud
Database Management System (DBMS)			
Computer software applications that interact with the user, other applications, and the database itself to capture and analyze data.	Yes	Yes - When capitalization criteria is met	Oracle Enterprise Manager
Enterprise Resource Planning System			
Commercial software that integrates business information flowing through the Component. ERP systems contain functional modules (e.g., financial, accounting, human resources, supply chain, and customer information) that are integrated within the core system or	Yes – portions of ERP systems are IUS (excluding any hardware acquired as part of the system)	Yes – portions of ERP systems are capitalized	Navy ERP, GFEBS, LMP, DAI

Definition	IUS	Capitalization	DoD Examples*
interfaced to external systems			
Firmware			
A program recorded in permanent or semi-permanent computer memory.	No – may be capitalized as part of equipment	No	Radar system software, lathe software
Freeware / Open Source Software (OSS)			
Software that is offered at no cost	No	No	Internet browser
Hardware			
The physical components of IT, including the computers, peripheral devices such as printers, disks, and scanners, and cables, switches, and other IT equipment.	No	May be capitalized as general equipment depending on applicable threshold	Router, Server, Modem, Switch
License – Annual			
A software license that must be renewed annually to continue using the software.	Yes	No - an annual license does not meet the useful life criteria of 2 years for capitalization	Microsoft Lync, VMWARE vSphere
License – Enterprise			
A license that allows use of the software throughout an organization or for a specified number of users.	Yes	Only if it meets capitalization threshold and capital lease criteria	Microsoft office, Oracle
License – Perpetual			
A software license that gives the Department the right to use the software in perpetuity.	Yes	Only if it meets capitalization threshold	SAP Chrystal Reports
Middleware			
Computer software that provides services to software applications beyond those available from the operating system.	Yes	Yes - If the system it is part of meets capital criteria	Linux Kernel
Portal			
Web-based application that provides personalization, single sign-on, and content aggregation from different sources, and hosts the presentation layer of information systems	Yes	Yes – When capitalization criteria is met	Audit Response Center (ARC) Tool
Simulation Software			
Based on the process of modeling a real or proposed system with a set of mathematical formulas that allows	Yes	Yes – When capitalization criteria is met	F-35 Lightning II Training Software

Definition	IUS	Capitalization	DoD Examples*
the user to observe an operation before performing it.			
Operating System			
The software that controls the execution of other computer programs, schedules tasks, allocates storage, manages the interface to peripheral hardware, and presents a default interface to the user when no application program is running.	No - except in circumstances noted in FAQ#16	Include in equipment costs	Windows, Linux
System / IT System			
The term "system" by itself is not limited to any specific resource. A system may be any two resources that work together to produce a specific outcome. Internal use software may or may not be one component of an overall "system".	Yes – software components of a system or IT system are IUS.	Yes - When capitalization criteria is met	Navy ERP, GFEBS, DAI, CAMIS, MC4
Utility Program			
System software designed to perform a particular function or system maintenance.	No - except in circumstances noted in FAQ#16	Include in equipment costs	CD burner, Disk defragmenter, virus scan
Web Application			
An application that is accessed via the web over a network.	Yes (assuming it is owned by a DoD Component)	Yes - When capitalization criteria is met	Outlook webmail

*DoD examples provided may or may not be capitalized