

ASU 2025-06:

Targeted Improvements to the Accounting for Internal-Use Software



Executive Summary

In September 2025, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2025-06, Intangibles Goodwill and Other-Internal-Use Software.



This Update amends the FASB Accounting Standards Codification (ASC) for Subtopic 350-40, focusing on modernizing the accounting for internal-use software costs. The amendments respond to stakeholder feedback indicating that the existing guidance is outdated and lacks relevance.

The existing guidance mandated the capitalization of costs sequentially based on each stage of software development i.e. Preliminary Project Stage, Application Development Stage, and Post-implementation Operation Stage. However, this method is not well-aligned with modern software development, where planning, coding, and testing often happen iteratively and simultaneously. Hence, many entities have shifted to incremental and iterative development methods, such as "agile," which allows for adaptation and frequent changes in performance requirements.

Due to lack of guidance on the incremental development model, entities found it challenging to differentiate between the project stages which further led to difficulties in determining when to begin capitalizing internal-use software costs.

The new guidance addresses these concerns by removing all references to prescriptive and sequential software development stages by establishing a clear capitalization threshold.

The guidance also specifies that the property, plant and equipment disclosure requirements under ASC 360-10 apply to capitalized software costs accounted for under ASC 350-40. This will give investors more consistent information about an entity's internal-use software costs.



Scope:



The amendments in this guidance apply to all entities that incur costs for developing or obtaining software for internal use.

The amendments also apply to all entities that currently account for website development costs in accordance with Subtopic 350-50, Intangibles Goodwill and Other-Website Development Costs. (Subtopic 350-50 is superseded, and its relevant guidance is incorporated into Subtopic 350-40.)

The amendments do not affect software costs accounted for under Subtopic 985-20, Software Costs of Software to Be Sold, Leased, or Marketed (referred to as external-use software). Also, the determination of whether software is accounted for under Subtopic 350-40 or Subtopic 985-20 remains unchanged by this Update.

Furthermore, the amendments are expected to result in a decrease in software capitalization for the development of software provided via a Cloud Computing Arrangement (CCA), better aligning the accounting outcome with that of software sold via an on-premises license.

For example, a company developing a cloud-based HR system using Software-as-a-Service (SaaS) model, used to capitalize \$1 million in development costs under old rules. With ASU 2025-06, it must wait until major uncertainties are resolved before capitalizing. The company noted, \$600,000 was incurred before resolving the uncertainties. As a result, only those costs that are incurred after the major uncertainties are resolved qualifies for capitalization i.e. \$400,000, while all the previous costs i.e. \$600,000 must be expensed. This change reduces capitalized costs and increases short-term expenses, better reflecting the nature of agile, cloud-based development.

Key Accounting Changes:

The ASU implements targeted improvements primarily by revising the criteria for when an entity is required to begin capitalizing internal-use software development costs as follows:

Recognition Threshold

An entity must now begin capitalizing costs when both of the following requirements are met:

Authorization and Funding:

Management has authorized and committed to funding the software project. Examples include executing a contract with a third party or approving expenditures for internal development.



Probable-to-Complete Threshold:

It is probable that the project will be completed, (subject to significant development uncertainties) and the software will be used to perform the function intended.



Capitalization ceases no later than the point at which the software project is substantially complete and ready for its intended use, which is defined as after all substantial testing is completed.

Significant Development Uncertainty (SDU):

The probable-to-complete threshold is not met if significant development uncertainty (SDU) exists; SDU must be resolved before capitalization can begin. The evaluation of SDU is required for all internal-use software projects.

Significant development uncertainty exists if either of the following two factors is present:



Novel or Unproven Software

The software has technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to them has not been resolved through coding and testing.

Significant Performance Requirements

The significant performance requirements (what the entity needs the software to do, such as functions or features) have not been identified, or the identified significant performance requirements continue to be substantially revised.

Example: A healthcare company is developing a new AI-powered diagnostic tool for internal use. The tool is designed to analyze patient data and predict potential health risks. The company begins development using a novel machine learning algorithm that has not yet been proven effective in clinical settings. At this stage, there is significant uncertainty about whether the algorithm will function as intended, meet regulatory requirements, or integrate with existing systems. Because of these unresolved uncertainties, the company cannot begin capitalizing development costs. Hence, all costs incurred during this phase must be expensed.

Presentation and Disclosure requirements

PP&E Disclosures Required:

The amendments mandate that the disclosure requirements in Subtopic 360-10 (Property, Plant, and Equipment-Overall) must be applied to all capitalized costs accounted for under Subtopic 350-40. This is required regardless of how those software costs are presented in the financial statements (e.g., as an intangible asset).

This ensures consistent information about an entity's internal-use software costs, including licensed internal-use software, which must be classified as an acquired intangible asset.

The guidance does not change the presentation requirements of software costs in the financial statements, only disclosures related to these costs are now required to be given with PP&E disclosures.

Intangibles Disclosures Not Required: The Update clarifies that the intangibles disclosures in paragraphs 350-30-50-1 through 50-3 are not required for capitalized internal-use software costs accounted for under Subtopic 350-40.

Cash Flow Presentation (Rejected Provision): The FASB decided not to carry forward the proposed requirement that cash paid for capitalized internal-use software costs be presented separately as investing cash outflows in the statement of cash flows. The Board rejected this requirement based on stakeholder feedback regarding complexity in separating cash and non-cash components.



Effective date and transition

The amendments are effective for all entities for annual reporting periods beginning after December 15, 2027, and for interim reporting periods within those annual reporting periods.

Early Adoption: Early adoption is permitted as of the beginning of an annual reporting period for financial statements that have not yet been issued or made available for issuance.

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Entities may apply the new guidance using one of three transition methods:

Prospective Transition Approach:

Applies to new software costs incurred as of the beginning of the period of adoption for all projects, including in-process projects.

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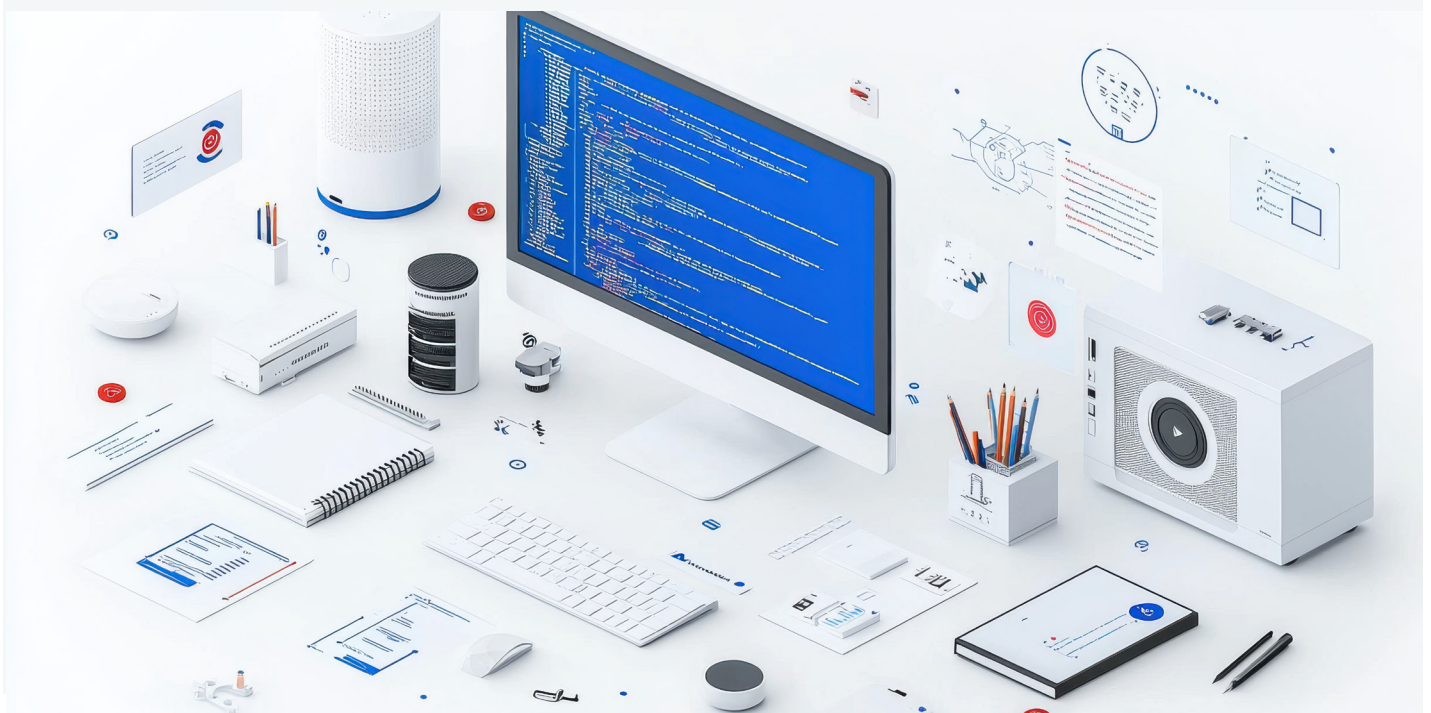
Retrospective Transition Approach:

The entity recasts comparative periods and recognizes a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity) as of the beginning of the first period presented.

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Modified Transition Approach:

Applies prospectively to new and in-process project costs, except for those in-process projects that do not meet the new capitalization requirements but had met the capitalization requirements before adoption of the new guidance. The costs related to those projects must be derecognized through a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) as of the beginning of the annual reporting period of adoption.





The Pie Perspective

The ASU 2025-06 is a much-needed evolution in accounting guidance that brings clarity and relevance to how internal-use software costs are treated. Its principles-based approach better reflects the realities of agile development, enabling more accurate financial reporting and fostering transparency for stakeholders. By requiring companies to expense costs until uncertainties are resolved, it reduces the risk of prematurely capitalizing expenditures in the financial statements.

However, the shift also introduces new complexities, determining when development uncertainty is resolved requires significant judgment, which can lead to inconsistencies if not carefully managed. Adapting internal systems, retraining teams to thoroughly assess the uncertainties, also demand time and resources. Additionally, because more costs may be expensed rather than capitalized, some companies could see short-term reductions in reported earnings, which may affect their performance metrics.

While the road to implementation may be demanding, the long-term benefits of consistency, comparability, and alignment with modern technology practices make this a worthwhile transition.



Pierag Consulting

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