NCUA Accounting Bulletin

NO. 97-1

DATE: December 1997

PURPOSE. To amend the "*Accounting Manual for Federal Credit Unions*" to provide accounting guidance with regard to costs a credit union incurs to modify systems and systems software to make it Year 2000 compliant.

BACKGROUND. Many systems and systems software are not programmed to accurately recognize system dates for Year 2000 and beyond. This condition exists because many systems were programed to use and store the last two digits of the year (1997="97"; 1998="98"; 1999="99", etc.). So when January 1, 2000 rolls around (and most likely before) many systems will read "00" and assume 1900, read an "error", or some other unknown alternative. All such systems will have to be reprogramed or retooled in some way to make them Year 2000 compliant.

Management is responsible for following generally accepted accounting principles (GAAP) in accounting for costs related to modifying systems and systems software to make them Year 2000 compliant. This section provides guidance in adhering to applicable GAAP measurement rules with regard to such costs. For advice beyond what is provided here, consult an independent accountant.

We will discuss a credit union's accounting for: (i) external and internal costs to modify existing internal-use computer software for the year 2000; (ii) purchases or development of software that replace existing software that is not year 2000 compliant; iii) training costs; iv) maintenance costs; and (v) related asset impairment issues.

POLICY. Modifying Existing Software for Year 2000. Costs to modify existing software to make it Year 2000 compliant must be charged to expense as incurred.

The Emerging Issues Taskforce (EITF) of the Financial Accounting Standards Board (FASB) in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, requires:

> ". . . external and internal costs specifically associated with modifying internal-use software for the year 2000 should be charged to expense as incurred."

EITF staff would object to the accrual of the costs of Year 2000 modifications before those costs are incurred. Likewise, the capitalization of such costs and subsequent depreciation or amortization is not permissible under GAAP.

Credit unions should expense these costs when incurred through the appropriate expense ledger account depending on type of expense: direct payroll costs (210, 220 series); material purchases (250, 260 series), etc.

Example #1 -- ABC Credit Union needed programming changes made to existing systems software to make it Year 2000 compliant. Some of the work was performed in-house by employees with programming skills; other portions required the hiring of outside contractors to effect the necessary programming modifications. ABC Credit Union recorded the following entry on its books:

(a) To establish the period accrual for salaries incurred in reprogramming systems to be Year 2000 compliant.

Dr. - Compensation Expense (210 Series)	$1,500.00	
Dr. - Employee Benefits (220 Series)	418.00	
Cr. - Accrued Salaries (Acct. No. 851)		$1,382.00
Cr. - Accrued Employee Benefits (Acct. No. 852)		418.00
Cr. - Withholding Taxes Payable (840 Series)		118.00

(b) To record period expenses for outside service costs:

Dr. - Professional and Outside Services (290 Series)	$3,000.00	
Cr. - Cash (Acct. No. 731)		$3,000.00

Development or Purchases Of Internal-Use Software That Replace Existing Software

Provided such internal-use software is not research and development related, the costs of computer software developed or obtained *for internal use* should be capitalized as a long-lived asset and depreciated over its useful life.

Internal use software is that which both:

- Is acquired, internally developed, or modified solely to meet the credit union's internal needs, and
- For which, during the software's development or modification, no plan exists to market the software externally.

Note: The capitalization rules do not apply to internal use software included in research and development efforts. Nor should the preliminary project costs be capitalized. Preliminary project costs include tasks such as making strategic decisions to allocate resources between project alternatives, developing high-level performance specifications, exploring alternatives to achieve specified performance (make or buy software? mainframe or client server system? etc.), or selection of a vendor. All these costs (research and development, preliminary project costs) must be charged to expense when incurred.

When applicable, capitalizable costs include:

- External direct costs of materials and services consumed in developing or obtaining internal-use computer software.
- Payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project.
- Interest costs incurred while developing internal-use computer software.

Note: Excluded costs are overhead, training, and general and administrative costs; these costs should be expensed in the period in which they are incurred.

Capitalization should begin when both:

- Conceptual formulation, design, and testing of possible software project alternatives (preliminary project stage) have been completed; and
- Management authorizes the project, commits to funding and believes it is probable the project will be complete and the software used to perform the intended function.

Amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages. In this regard, the standards-setters did not specify a maximum amortization period. They judged that each credit union would be better able to determine an appropriate useful life. Credit unions should consider the effects of obsolescence, technology, competition, and other economic factors when making their useful life determinations. The *Accounting Manual for Federal Credit Unions* provides these guidelines.

AMORTIZATION PERIODS

	Lower Limit	**Generally Accepted Period**	**Upper Limit**
OFFICE FURNITURE, FIXTURES & EQUIPMENT: Includes furniture, fixtures and equipment which are not a structural component of a building, i.e., desks, files, safes, and communication systems	8	10	12
INFORMATION SYSTEMS:			

	Lower Limit	Generally Accepted Period	Upper Limit
Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of records, their retrieval and analysis	5	6	7
DATA HANDLING EQUIPMENT EXCEPT COMPUTERS: Includes typewriters, calculators, accounting machines, copiers, and other duplicating equipment, automated teller machines, etc.	5	6	7
COMPUTER SOFTWARE COSTS	5	5	5

Example #2 --After design and testing of possible software project alternatives and management's decision and authorization of funding, DEF Credit Union moved to purchase, in part, and to develop, in part, systems software to enhance its system while also ensuring Year 2000 compliance. Management expects the useful life of the new software to be 5 years. Old systems software will be obsolete and is planned for abandonment once the new software is functional.

(a) To record capitalization of salary costs as software is developed:

Dr. - Compensation Expense (210 Series)	$1,500.00	
Dr. - Employee Benefits (220 Series)	418.00	
Cr. - Accrued Salaries (Acct. No. 851)		$1,382.00
Cr. - Accrued Employee Benefits (Acct. No. 852)		418.00
Cr. - Withholding Taxes Payable (840 Series)		118.00
Dr. - Furniture and Equipment (770 Series)	$1,918.00	
Cr. - Compensation Expense (210 Series)		$1,500.00
Cr. - Employee Benefits (220 Series)		418.00

(b) To record capitalization of purchased software:

Dr. - Furniture and Equipment (770 Series)	$6,000.00	
Cr. - Cash (Acct. No. 731)		$6,000.00

(c) Once software is tested and functional, the periodic entry to record software amortization is:

Dr. -Furniture and Equipment Depreciation (260 Series)		$131.96	
Cr. -Allowance for Amortization of Furniture and Equipment (770 Series)			$131.96

Year 2000 Training Costs Training costs should be recognized as an expense as incurred. See the existing *Accounting Manual* guidance in Section 4040.2, account series 230s for training employees and 270s for educating members.

Maintenance Costs Maintenance fees should be recognized as an expense over the maintenance period. See the existing *Accounting Manual* guidance in Section 4040.2 for 260s Series.

Possible Impairment of Capitalized Internal-Use Software and Hardware Inventories of hardware devices that are not year 2000 compliant are subject to measurement at the lower of cost or market. The entry would be reflected as a charge against the revenues of the period in which the hardware is impaired by damage, deterioration, obsolescence, or other causes.

The Year 2000 issue may indicate impairment of fixed assets containing software or hardware components (e.g., microchips), and for capitalized costs of software developed or obtained for internal use that has not been modified to be year 2000 compliant.

Events which may indicate impairment to internal-use software include:

- Internal-use software is not expected to provide substantive service potential.
- Significant change occurs in the extent or manner in which the software is used.
- A significant change is made or will be made to the software program.
- Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

Such assets:

- To be held and used must be reviewed for impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

  In determining if impairment exists, the credit union should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized.

Measurement of an impairment loss should be based on the fair value of the asset.

- To be disposed of must be reported at the lower of carrying amount or fair value, if any, less cost to sell.

The Year 2000 issue also could affect estimates of asset useful lives used in depreciation and amortization calculations. Credit unions should consider the effects of obsolescence, technology, competition, and other economic factors when making their useful life determinations.

Example #3 --GHI Credit Union has obsolete non-compliant software it intends to dispose of through eventual abandonment. The book value of the software is $4,000.00 ($5,000 less accumulated amortization of $1,000); its fair value is $750.00. The software has no continued useful life.

(a) To write-down to fair value, non-compliant computer software, to reflect obsolescence -- software to be disposed of (eventual abandonment) -- no remaining useful life:

Dr. - Allowance for Amortization of Furniture and Equipment (770 Series)	$1,000.00	
Dr. - Furniture and Equipment (770 Series)	750.00	
Dr. - Loss on Disposition of Assets (440 Series)	3,250.00	
Cr. - Furniture and Equipment (770 Series)		$5,000.00

EFFECTIVE DATE. This Bulletin is effective beginning January 1, 1998, and will remain in effect until incorporated into the *Accounting Manual for Federal Credit Unions*.

Daniel L. Murphy
Acting Executive Director

OEI
DISTRIBUTION: C
All FICUs
All State Supervisory Authorities (2)
Leagues and Trades (2)