

Office of Inspector General



March 29, 2002
Audit Report No. 02-014

Capitalization of Internal-Use Software Development Costs





DATE: March 29, 2002

TO: Carol M. Heindel, Acting Director
Division of Information Resources Management

Fred S. Selby, Director
Division of Finance

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Capitalization of Internal-Use Software Development Costs*
(Audit Report No. 02-014)

The Office of Inspector General (OIG) completed an audit of the FDIC's internal controls for capitalizing software development costs. The objective of the audit was to assess the adequacy of internal control activities for ensuring that the costs of developing internal-use software¹ are accounted for and capitalized appropriately. Appendix I provides details on the scope and methodology.

BACKGROUND

On January 1, 1998, the FDIC adopted the American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) Number 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*. SOP 98-1 provides guidelines to ensure that entities properly determine the types of internal-use software to report as assets subject to amortization² or classify as current period expenses. Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Capitalization involves the classification of costs into asset categories when it is determined that those costs provide probable future benefits to the entity. Capitalized costs are assets that appear on the statement of financial position with offsetting measured periodic amounts representing when the entity uses an asset's benefits.

¹ AICPA Statement of Position 98-1 uses the term, "internal-use software," to describe the costs of computer software developed or obtained for internal use within an organization. Such costs include those associated with such software activities. FDIC groups these costs into three categories: payroll, procurement, and travel. Throughout this report, we use the abbreviated term, "internal-use software," to capture the SOP 98-1 topic.

² Amortization is an accounting term which means to write-off the asset over a specified period of time.

Capitalizing future benefits as assets and amortizing the usefulness over time matches economic benefits realized with the periods in which an entity realizes those benefits. For example, by internal FDIC estimates, costs associated with the FDIC's computer software used to administer paperless procurement activities benefit the FDIC for 5 years. The FDIC incurs the cost of establishing that system up front in the first year, but measures one-fifth of the initial investment to record it as an expense in each of the 5 ensuing years. The accumulation of amounts expensed over the 5-year timeframe appear on the financial statements as an offset to the initial asset. This accounting treatment matches the expense of using the software to the periods of software use, and the asset balance is periodically reduced to reflect its lesser value to the FDIC as usefulness expires.

SOP 98-1 guidelines specify which internal-use software-related costs entities are to capitalize. Included are outside procurements of goods and services, employee payroll and payroll-related expenditures (employee benefits), and training costs incurred during the application development phase. SOP 98-1 further specifies which stages of an internal-use software project are to be expensed or capitalized. Projects go through three stages: preliminary project stage, application development stage, and post-implementation/operation stage. The first stage generally involves evaluating alternatives to meet performance requirements and selecting consultants to assist with defining application requirements while the third stage involves training employees and performing maintenance. SOP 98-1 requires that costs incurred in the first and third stages be expensed in the current period. The second stage, application development, includes software configuration, interfaces, coding, installation procedures, and testing the software. It is only in this second stage, application development, that SOP 98-1 concludes entities should capitalize costs and spread the initial investment over future periods.

The FDIC's Division of Information Resources Management (DIRM) established the FDIC's capitalization threshold policy of expensing internally-developed software with amounts under \$200,000. That is, if a project's benefits to the FDIC extend beyond the current year and total project costs do not exceed \$200,000, the costs are not capitalized but are instead included in the current year's operating expenses. Otherwise, costs are capitalized.

DIRM administers all FDIC internal-use software projects. Other FDIC offices and divisions rely on DIRM to translate requests for computer-related tasks into applications satisfying the FDIC's operational needs. As of December 31, 2000 (the FDIC's most recent audited financial statements), \$110 million (\$98 million net of amortization) of expenditures related to internal-use software were included in the FDIC's financial statement asset accounts.

The FDIC's operating plans include the acquisition/development of new internal-use software in the near future, some of which will involve substantial information system resource investments. For example, the FDIC's efforts to enhance or replace its existing automated accounting system, its New Financial Environment,³ could cost the Corporation up to \$62.5 million. The costs associated with this project will be accounted for under the AICPA's SOP 98-1.

³ The New Financial Environment is a project to develop an integrated system solution that further enhances the FDIC's ability to meet current and future financial management and financial information needs.

RESULTS OF AUDIT

The FDIC's control activities were generally adequate to ensure that internal-use software of approximately \$100 million⁴ was accounted for and capitalized in accordance with SOP 98-1. Project Managers reviewed and approved application development expenditures that ultimately were recorded as capitalized costs and analyzed variances between actual and estimated costs to identify expenditures that should not be included in the established asset for internal-use software. The Division of Finance (DOF) administers automated cut-off controls to ensure that completed projects' costs are final for financial reporting purposes, and no additional costs are added to such projects. Also, the FDIC generally captured appropriate procurement costs, travel costs, FDIC employee salary expenses, and a portion of employee fringe benefit costs related to the application development stage of internal-use software from January 1998 through August 2001.

However, the FDIC could further improve its compliance with SOP 98-01 and the accuracy of its accounting for capitalized internal-use software costs. For instance, the FDIC had not implemented policies and procedures to identify all employee leave and fringe benefit costs associated with internal-use software application development projects. As a result, from January 1998 through August 2001, approximately \$4.5 million of internal-use software costs were not included in the capitalized amounts. Further, approximately \$213,000 of human resources costs were omitted from capitalized internal-use software projects because the accounting function within DOF was not consistently made aware of each division's internal-use software related costs. Also, the FDIC did not periodically review capitalized internal-use software projects and determine whether the projects remained in use. As of October 31, 2001, the FDIC's accounting records included capitalized internal-use software, including related equipment, valued at \$967,374 net of amortization that were no longer used by the FDIC.

OMISSION OF EMPLOYEE LEAVE AND OTHER COSTS

The FDIC does not capitalize all applicable internal-use software project-related costs on an organization-wide basis. Employee leave expenses and other fringe benefits comprised the largest portion of software development costs omitted from capitalized internal-use software costs. Specifically, the FDIC's DIRM is the only FDIC division that, with few exceptions, has accounting policy requiring that all DIRM expenditures be identified with specific FDIC projects. FDIC divisions and offices outside of DIRM devote resources to the development/acquisition of internal-use software without consistently accounting for the corresponding expenses in the capitalized project balances. Consequently, the FDIC did not capitalize approximately \$4.5 million in leave and fringe benefits costs (Appendix III shows the calculation of the \$4.5 million) and approximately \$213,000 in human resources costs devoted to internal-use software projects.

The FDIC prepared its own internal internal-use software policy through DOF Statement of Accounting Policy Number 21 (SAP 21), *Accounting for Capital Assets*, which requires the FDIC to capitalize the following costs:

- External direct costs of materials and services (third party fees, software purchase costs, etc.).

⁴ Amount as of October 31, 2001.

- Payroll and payroll-related (fringe benefits) costs for employees assigned to work on projects.
- Travel costs incurred by employees assigned to the project.
- Software development or purchase costs incurred to allow access or conversion of data to the new system.
- Internal and external costs incurred for specified upgrades and enhancements, if additional functionality is probable.

SAP 21 policy applies equally to every FDIC office and division. Further, the FDIC's internal definition of employee payroll is included in FDIC Circular 4310.1, *Utilizing Cost Benefit Analysis Methodology for the Purchase or Development of Capital Assets*. Circular 4310.1 defines such payroll costs to include personnel compensation (base pay, regional pay differential, etc.) plus benefits (insurance, pensions, vacation, sick time, employer payroll taxes, etc.). Excerpts from referenced sources are included in Appendix II of this report.

The FDIC's DOF established an FDIC-wide policy on using project numbers in DOF Accounting Bulletin #99-02, *Accounting for Capital Assets*. In accordance with Bulletin #99-02, internal-use software project costs are to be tracked by project numbers. While Bulletin #99-02 does not specify the use of time and attendance forms to account for employees' project-related hours, the FDIC's time and attendance form accommodates inclusion of the project number on each line. The FDIC's travel voucher forms and procurement requisition forms also provide a data field for project numbers. DOF issued further project number management guidance in Accounting Bulletin #99-001, *Project Number Management*, which provides that project numbers are used to capture expenditures related to special reportable activities and to capture expenditures on capitalized assets.

Generally, FDIC employees do not identify all leave hours in a manner that will allow their costs to be accumulated as part of the project development costs of internal-use software. Therefore, leave costs are not consistently capitalized for internal-use software projects.

The FDIC has established a means of accumulating the amount of leave that is taken by employees through the employee's individual time and attendance forms. This system would be effective for capturing sick leave taken by employees with a corresponding project number because sick leave is expensed only when used by employees. However, few employees identify any of their leave transactions with project numbers, even if they identify their regular time worked with these numbers. Even within DIRM, where accounting policy is to account for all DIRM expenditures through project numbers, internal-use software project balances do not include a full accounting of employee leave expenses.

The FDIC does not have an effective system for capturing annual leave earned by employees for the purpose of allocating the appropriate costs of the annual leave earned to the capitalized software project costs. The time and attendance forms would only capture annual leave used, not leave earned. Since annual leave is part of an FDIC's employee compensation, it is expensed when it is earned, not when taken. Therefore it is difficult under the current FDIC practices to ensure a full and accurate accounting of FDIC leave-related project costs. From our discussions with personnel in DIRM who worked on internal-use software projects and analysis of time and attendance documents, we estimate that an

additional \$4.5 million of DIRM employee leave expenditures were not identified and properly charged to internal-use software costs that would have been capitalized. We have not estimated the additional leave costs that would be added from the other divisions and offices that should also be capitalized.

Omission of Project-related Costs of Other Divisions and Offices

Our review of a selection of internal-use software projects between January 1998 and August 2001 indicated that the FDIC divisions and offices did not always capture their direct project-related costs for inclusion with the capitalized internal-use software costs. The results from our analysis of projects and discussions with employees assigned to the project teams showed that the FDIC divisions and offices devoted at least 5,200 employee hours to internal-use software activities without assigning project numbers to staff time incurred. Using the Division of Administration's estimated \$85,000 average FDIC employee annual salary, the 5,200 hours equates to approximately \$213,000 in salary costs improperly omitted from internal-use software project costs. Therefore, these costs were not captured as part of the total costs on the projects to be capitalized.

Similar Issue in Prior OIG Audit

We also noted that FDIC divisions were not consistently tracking and reporting information technology project costs in a previous audit. Our report entitled *Audit of FDIC Resource and Cost Tracking Systems for Information Systems Projects* (Audit Report Number 98-019, dated February 27, 1998) has as its first recommendation, "Work with representatives of FDIC's business units to develop the capability to track and report total costs associated with IT projects, including program office costs, data processing services, telecommunication services, and PC/LAN server operations." The FDIC's (DIRM and DOF) February 9, 1998 response to our recommendation was, "During 1997, the importance of capturing the costs of capital assets, including IT costs, was recognized. As a result, the Corporation is formalizing its "Accounting for Capital Assets" initiative, which will be effective for the 1998 budget year." While DOF developed the Accounting for Capital Assets bulletin, it is not fully effective in capturing all costs related to internal-use software.

Since our audit tests did not cover 100 percent of all internal-use software activity, total omissions of project-related costs from internal-use software during January 1998 through August 2001 include more than the amounts presented in our report. Our results for 1998 through August 2001 indicate that an estimated \$4.5 million of internal-use software project leave and other expenses, and approximately \$213,000 in project-related employee salary expenses were omitted from internal-use software projects. In addition, FDIC policy does not ensure an across-the-organization full accounting of internal-use software costs.

Recommendations

We recommend that the Director, Division of Finance:

- (1) Determine the total January 1998 through August 2001 amounts not included in the internal-use software costs and assess the need to adjust the general ledger for dollar amounts omitted.

- (2) Clarify the FDIC's policy to capture all internal-use software costs incurred by all divisions/offices by communicating that the corporate policy requires complete and consistent inclusion of payroll, payroll-related costs, and other project-related costs as these pertain to internal-use software and providing guidance to employees required to account for time based on this information.

SOFTWARE PRODUCTS NO LONGER USED

There were 94 internal-use software development projects (7 of which had \$0 book value; 3 others represented project equipment purchases only – no software development activity) included in the FDIC's December 31, 2000 financial statement asset balances. The October 2001 statuses of those 94 projects, as provided by office/division staff having project oversight responsibilities, indicated that 7 projects were no longer in use. The FDIC had not implemented periodic review procedures to remove internal-use software projects no longer in use from FDIC asset accounts. The capitalized amounts of the seven projects represent amounts in asset accounts that no longer provide value to the FDIC and, according to FDIC policy, are improperly included in the FDIC's asset accounts. The following table shows that retaining the costs for the seven projects on the general ledger overstates gross fixed assets by \$2.3 million (\$967,374 net of depreciation) as of October 31, 2001.

Table 1: Projects Not Removed From Fixed Assets

Project Number	FDIC User Divisions	Project Description	Net of Amortization	Initial Investment Amount
D9828	Corp-wide	Year 2000 Software Support	\$9,374	\$23,968
D9742	Division of Compliance and Consumer Affairs (DCA)	Maps banks' lending activities prior to DCA examinations	\$209,321	\$358,836
D9760	DCA	PC-based data gathering software that consolidates info for DCA case manager	\$35,328	\$73,104
D9747	Division of Administration (DOA)	Administrative Customer Request/Response System used to communicate DOA function	\$518,633	\$943,127
D9786 ^a	Corp-wide	Distance Learning Technology to reduce travel and increase productivity	\$44,373	\$640,310
D9909	DOF	Improve financial data access and management environment.	\$149,411	\$224,863
D9910	DOF	Routing of Disbursement Documents to accommodate E-Commerce processing	\$934	\$1,436

TOTALS \$967,374 \$2,265,644

^a Note: The total Project D9786 initial investment includes \$540,403 (\$754 net of accumulated depreciation through 10/31/01) of PC equipment acquired to facilitate the project. DOF need only remove the capitalized software portion of this project from the asset accounts, or \$43,619 (\$99,907 cost less \$56,288 accumulated amortization).

Source: FDIC General Ledger and Corporate-Wide Information Technology Plan

Internal-use software represents a relatively small portion of the FDIC's assets. Having inactive projects remaining among currently used assets misrepresents fixed asset amounts on the Corporation's financial statements. It also suggests that the FDIC's controls do not adequately monitor project status and provide for removing assets from the accounting records.

DOF SAP 21, *Accounting for Capital Assets*, includes the FDIC's policy on asset impairments. When the determination is made that internal-use software is no longer usable, SAP 21 provides the following: "Internal-use software being developed or currently in use will not likely have alternative uses. Consequently, the costs associated with impaired software should be written off." In other words, if capitalized software is no longer being used for its original intended purposes, DOF should take steps to remove the costs associated with such projects from the corporate accounting records. The accounting entry involves removing the asset balance and related accumulated depreciation, and recording any amounts not yet depreciated as a current period expense.

While SAP 21 provides clear guidance related to removal of unused internal-use software from fixed asset accounting records, it does not address appropriate timeframes in which DOF should account for those unused assets. Without established timeframes for removing unused assets, such assets can remain in the accounting records until they become fully depreciated.

Recommendations

We recommend that the Director, Division of Finance:

- (3) Remove the costs associated with inactive projects from the Corporation's fixed asset accounts.
- (4) Include in DOF policy the assignment of responsibility and specific timeframes for monitoring capitalized internal-use software projects and removing from asset accounts those internal-use software projects no longer in use.

CORPORATION COMMENTS AND OIG EVALUATION

The Director, DOF, provided a written response, dated March 22, 2002, to the draft report. DOF's response is presented in Appendix IV to this report. Subsequent to receipt of management's response, we held discussions with DOF representatives to further clarify portions of the response. Our report did not include recommendations to DIRM, and DIRM provided no comments on our draft report.

DOF's comments were responsive to our recommendations, and we consider recommendations 1 through 4 resolved. Recommendation 3 is dispositioned and closed. Recommendations 1, 2, and 4 will remain open for reporting purposes until we have determined that agreed-to corrective actions have been taken and are effective. A summary of each recommendation, corrective actions, and milestones follows:

Recommendation 1: Determine the total January 1998 through August 2001 amounts not included in the internal-use software costs and assess the need to adjust the general ledger for dollar amounts omitted.

DOF agrees that our assessment of \$4.5 million in fringe benefit and leave expenses attributable to internal-use software projects is a reasonable estimate of amounts not included in capitalized internal-use software projects. DOF also assessed the need to adjust the general ledger and determined that neither the \$4.5 million nor our determination of omitted human resource costs are material enough to warrant prior period adjustments to the general ledger for the years 1998 through 2001. The \$4.5 million represents internal-use software expenditures throughout the nearly 4-year period. DOF stated that even if amounts had been capitalized correctly, a substantial portion of the initial outlays would already be amortized. Since the net amounts of any prior period adjustments would be significantly smaller than the \$4.5 million, DOF believes that no prior period adjustments to the FDIC accounting records should be made.

However, for future periods, DOF will address implementing accounting mechanisms for capitalizing personnel fringe costs in its New Financial Environment (NFE) project to be implemented in 2004. For those personnel fringe costs subject to capitalization between August 2001 (our audit fieldwork completion date) and year-end 2003, DOF will explore developing an efficient means of capturing and capitalizing such costs without modifying the existing accounting system. DOF intends to determine practical alternatives for those interim costs by October 1, 2002. DOF will further make the necessary accounting adjustments if deemed appropriate by year-end 2002 and year-end 2003, for the fringe expenses to be capitalized in each of those years, respectively. We accept DOF's position on the prior period adjustments and agree with DOF's proposed course of action to ensure accurate accounting of internal-use software development costs for the future.

Recommendation 2: Clarify the FDIC's policy to capture all internal-use software costs incurred by all divisions/offices by communicating that the corporate policy requires complete and consistent inclusion of payroll, payroll-related costs, and other project-related costs as these pertain to internal-use software and providing guidance to employees required to account for time based on this information.

DOF's response cited a number of memorandums going back to 1998 and a more recent global message sent to all employees regarding the need for assigning project numbers and using them for all accounting documents related to payroll, travel, requisitions, purchases and contracts. In subsequent communication, DOF committed to exploring methods to better ensure that charges for internal-use software projects are being properly coded and capitalized. This will include direct contact with the Project Oversight Managers in order to ensure that they understand their monitoring responsibilities related to correct coding as well as tools available to assist them in this effort. DOF will evaluate how such methods improve project cost tracking by October 1, 2002.

Recommendation 3: Remove the costs associated with inactive projects from the Corporation's fixed asset accounts.

DOF removed the inactive project balances from the FDIC's financial records on November 1, 2001. We confirmed that the general ledger balances reflected the appropriate adjustment.

Recommendation 4: Include in DOF policy the assignment of responsibility and specific timeframes for monitoring capitalized internal-use software projects and removing from asset accounts those internal-use software projects no longer in use.

On March 22, 2002, the Director, DOF, issued a memorandum, "Confirmation of FDIC Internally Developed Software," to FDIC Division and Office Directors. This memorandum contained a listing of active projects, by division and office. All Division and Office Directors were asked to confirm that their respective projects remain in active status by April 1, 2002. Through this communication and the periodic re-issuance of this same memorandum, DOF will provide ongoing monitoring of inactive project balances and apply appropriate accounting procedures.

SCOPE AND METHODOLOGY

Our audit objective was to assess the adequacy of internal control activities for ensuring that internal-use software development costs are accounted for and capitalized appropriately. The FDIC implemented software development cost capitalization procedures as of January 1, 1998. Our audit scope covered FDIC's capitalized software projects between January 1, 1998 and August 31, 2001. We based our conclusions and recommendations on audit tests of the FDIC's accounting records, internal management reports, and interviews with FDIC officials.

We reviewed the universe of capitalized software development projects included in the asset account balance on the FDIC's financial statements. We retrieved all the FDIC Financial Information Management System (FIMS) transactions in which employee leave accounts were associated with project numbers. We also identified the entire universe within FIMS of DIRM expenditures processed without project numbers.

We determined whether the projects shown as assets at December 31, 2000 were all still actively used through inquiries of office/division staff having project oversight responsibilities on all such capitalized internal-use software projects. To review potential hours not properly included in internal-use software projects, we examined, through program office interviews, a nonrepresentative selection⁵ of 13 out of 94 internal-use software projects.

We reviewed existing capitalization policies and procedures to determine whether the FDIC's financial reporting complies with generally accepted accounting principles. We also reviewed current FDIC practices to assess compliance with applicable laws, which require the FDIC to maintain separately and not commingle the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), 12 U.S.C. §1821[a][4][A], and not consolidate the assets and liabilities of the BIF and/or SAIF with the Federal Savings and Loan Insurance Corporation Resolution Fund, 12 U.S.C. §1821a(a)(3).

We performed our audit from August through October 2001 in accordance with generally accepted government auditing standards.

⁵ GAO's Financial Audit Manual, Section 480.06, defines nonrepresentative selection as being appropriate where the auditor knows enough about the population to identify a relatively small number of items of interest. Usually the auditor selects items because of a high likelihood of misstatements or other high risk. As the term implies, being "nonrepresentative" prevents projections of results to the universe, and "selection" describes a manner of choosing some items from a larger group for examination. The GAO term is an apt definition of the procedures undertaken in this audit.

**GENERALLY ACCEPTED ACCOUNTING STANDARDS AND
APPLICABLE PRONOUNCEMENTS**

Standards for Internal Control in the Federal Government, GAO/AIMD-00-21/3/1. The Section entitled, *Accurate and Timely Recording of Transactions and Events*, states: “Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded.”

AICPA Statement of Position 98-1, Paragraph .31 provides: “Costs of computer software developed or obtained for internal use that should be capitalized include only the following: Payroll and payroll-related costs (for example, costs of employee benefits) 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.”

FDIC’s October 1998 Statement of Accounting Policy 21 (SAP 21), “Accounting for Capital Assets,” lists costs to be capitalized: “Capitalize the following costs: Payroll and payroll-related (fringe benefits) costs for employees directly associated with the project.” Regarding the corporate policy on asset impairments, SAP 21 states, “However, internal-use software being developed or currently in use will not likely have alternative uses. Consequently, the costs associated with impaired software should be written off.”

FDIC’s Accounting Bulletin 99-01. This Bulletin provides that “Project Numbers are used for two primary purposes: (1) to capture expenditures related to special reportable activities of the Corporation and (2) to capture expenditures on capitalized assets. Examples of reportable activities and expenditures for capitalized assets include: Information Technology Projects.”

FDIC Circular 4310.1, Utilizing Cost Benefit Analysis Methodology for the Purchase or Development of Capital Assets, July 1998. This Circular primarily serves as a guide for evaluating cost/benefit decisions regarding capital assets. Regarding capitalized internal-use software development projects, Attachment D defines the general cost elements to include in capital asset decisions. Paragraph 1.a. cites, “Labor. This includes personnel compensation (base pay, Regional Pay Differential, etc.) plus benefits (insurance, pensions, vacation, sick time, employer payroll taxes, etc.)”

**Capitalization of Software Development Costs
Prorated Salaries/Expenses Not Identified by Project Numbers
January 1, 1998 through August 31, 2001**

Internal-Use Software Project Salaries

Determination of percentage of FDIC salaries related to Internal- Use Software Projects by year for 1998 - 8/2001.

Year	FDIC Salaries Identified by Project Numbers	FDIC Salaries Associated With Internal-Use Software Projects	Percent (Calculated)
1998	\$57,606,089	\$9,032,930	15.7%
1999	72,465,370	6,160,984	8.5%
2000	62,198,392	6,378,816	10.3%
1/1-8/31/2001	36,643,191	2,827,358	7.7%
Totals	\$228,913,042	\$24,400,088	10.7%

Source: FDIC Financial Information Management System (FIMS) Queries

Proration of DIRM Expenses

Proration of DIRM Expenses not Identified with Project #s to Internal- Use Software Projects.

Year	DIRM Expenses Without Project # Identification	Percent from Above	Prorated Portion of Expenses w/o Project Number (Calculated)
1998	\$10,148,302	15.7%	\$1,593,283
1999	11,639,901	8.5%	989,392
2000	11,554,528	10.3%	1,190,116
1/1-8/31/2001	9,725,145	7.7%	748,836
Totals	\$43,067,876		\$4,521,627

Source: FDIC Financial Information Management System (FIMS) Queries

March 22, 2002

TO: Sharon M. Smith, Deputy Assistant Inspector General for Audits
Office of Inspector General

FROM: Fred S. Selby [Electronically produced version; original signed by Fred S. Selby],
Director
Division of Finance

SUBJECT: Division of Finance Response to Draft Report Entitled *Capitalization of Internal Use Software Development Costs* (Assignment Number 01-530)

Pursuant to the above subject matter, this memorandum will serve to respond to the issues and recommendations outlined in the draft OIG Audit Report dated February 22, 2002.

OIG Recommendation (1):

Determine the total January 1998 through August 2001 amounts not included in the internal-use software costs and assess the need to adjust the general ledger dollar amounts omitted.

DOF Response (1):

The Division of Finance (DOF) agrees that all employee fringe benefit and leave costs associated with internal-use software application development are not being capitalized. DOF feels that the OIG calculation of \$4.5 million in fringe benefit and leave expenses that were attributed to internal-use software projects and not capitalized is reasonable. DOF does not feel that the \$4.5 million in fringe benefit and leave costs over a four year period, nor the \$213,000 in human resource costs, that were not capitalized are material enough to warrant prior period adjustments to the general ledger for the years 1998 through 2001.

While DOF agrees that not all of the above costs are being capitalized, there are no plans in place to expend funds to enhance our current systems to allow for the capture and capitalization of these costs. However, DOF will explore a permanent solution to this issue by creating a mechanism for calculating project related fringe benefit and leave costs as part of the New Financial Environment project. This possible solution, involving the addition of an estimated percentage factor to the project salary costs in order to calculate the employee fringe benefit and leave costs to be capitalized, will be reviewed. DOF believes that this solution offers a more efficient means of attributing these costs as opposed to direct coding.

In the interim (prior to NFE implementation), DOF will explore alternative ways of capturing and capitalizing fringe and leave costs associated with internal-use software development. If we can develop an efficient means of achieving this without spending funds to enhance the current system

or incurring unreasonable manual labor costs, we will capitalize these expenses in 2002 and 2003.

OIG Recommendation (2):

Clarify the FDIC's policy to capture all internal-use software costs incurred by all divisions/offices by communicating that the corporate policy requires complete and consistent inclusion of payroll, payroll-related costs, and other project-related costs as these pertain to internal-use software and providing guidance to employees required to account for time based on this information.

DOF Response (2):

DOF agrees it is important that FDIC's policy to capture all internal-use software costs is communicated to all divisions/offices. Consistent with this thought, DOF has been proactive in notifying divisions/offices that information application development projects must be assigned a "project number" and this number must be used for coding all accounting documents related to payroll, travel, requisitions, purchases, and contracts. This point was emphasized in a memorandum regarding "Accounting for Capital Assets" that was issued by Paul L. Sachtelban, Director, DOF to Donald C. Demitros, Director, Division of Information Resources Management (DIRM) and Jane Sartori, Director, Division of Administration (DOA), dated February 23, 1998. This point was reemphasized in another memorandum regarding "Accounting For Capital Assets" that was issued by Fred Selby, Acting Director, DOF to Donald C. Demitros, Director, DIRM and Jane Sartori, Director, DOA, dated September 29, 1998.

On November 23, 1998, DOF issued a memorandum regarding "Capital Accounting and Project Coding Guidance" to all FDIC Division and Office Administrative Officers, Budget Contacts, and IT Technical Committee Members. The memorandum provided the following specific instructions:

- If your division or office is involved in IT software development or maintenance efforts, contact your DIRM program manager to obtain a unique project number for each applicable project.
- Instruct your staff to include this unique number on each timesheet, PAV, or travel voucher associated with work on a given project.
- Over the development cycle of the project, keep abreast of the expenditures incurred for your division or office during the project. Check for reasonableness and follow up with the timekeepers and/or staff as needed.

On December 20, 1999, DOF also issued a memorandum regarding "Project Number Awareness/Coding Guidance" to All FDIC Division and Office Directors, IT Technical Committee Members, Administrative Officers, Budget Contacts, and Capital Asset Division and Office Contacts. The purpose of the memorandum was to raise awareness of the importance of project numbers and to provide guidance on understanding how and when to use project numbers.

DOF Response (2) - continued:

The memorandum stated the following:

“It is the responsibility of each employee, when working on activities that are assigned project numbers, to use that project number on all expense documents. These documents include Time and Attendance, Travel Vouchers, Purchase Orders and invoices approved for payment.”

“The support of each Division and Office is critical to the success of accurate financial reporting. Corporate managers, supervisors, administrative officers, budget contacts, project managers, contracting officers and financial/accounting managers must take an active role in providing guidance and assistance to:

- Ensure that employees or groups of employees charge their time and travel to specific project numbers when applicable.
- Review Time and Attendance Reports and Travel Vouchers to identify improper or incomplete charging of project numbers.
- Correct any Time and Attendance Reports, Travel Vouchers or Accounts Payable records to reflect correct project numbers.”

I issued a memorandum regarding the “Project Number Management Program” to All Division and Office Directors, dated December 7, 2000. The purpose of the memorandum was to announce an enhanced Project Number Management Program. The Project Number Management Program is a decision support tool to be used in evaluating both small and large initiatives tracked by project numbers. The management program, through better project definition and official designations of Project Oversight Managers (POMs), facilitates the gathering of better information used in analyzing project costs, benefits and decision making.

The memorandum specifically noted the following:

“The Division or Office, through its designated POMs, will be responsible for all management and administrative needs of the project. DOF will provide standard reports to facilitate monitoring, but the POM must monitor the report data to ensure that the respective participating organizations are coding their time and expenses correctly.”

“The POM should provide guidance to the employees of these organizations about when and how to use the newly assigned project number.”

I also issued a global message to all FDIC employees on July 23, 2001 announcing the availability of the Project Number Management Program Web Site. The roll out of the Project Number Management Program Web Site was also featured in an article contained in the July issue of the “FDIC News”. The global message and the “FDIC News” article once again announced the availability of a user friendly reporting tool designed to deliver Project Number Management Reports.

DOF Response (2) – continued:

The tool provides FDIC Managers and Project Oversight Managers with easy access to reports on information essential to manage projects including project salaries, travel costs, contractor expenses and other expenditures.

DOF will continue to take a proactive role in emphasizing to all FDIC employees the importance of properly coding all project related accounting documents, including payroll, travel, requisitions, purchases, and contracts.

OIG Recommendation (3):

Remove the costs associated with inactive projects from the Corporation's fixed asset accounts.

DOF Response (3):

DOF concurs with the OIG recommendation. The costs related to software products no longer in use, totaling \$967,374, that are noted on page 11 of the OIG draft were fully expensed and removed from the Capital Accounting System on November 1, 2001.

OIG Recommendation (4):

Include in DOF Policy the assignment of responsibility and specific time frames for monitoring capitalized internal-use software projects and removing from asset accounts those internal-use software projects no longer in use.

DOF Response (4):

DOF Accounting Bulletin - #99-002, entitled "Accounting For Capital Assets", and dated December 20, 1999, states the following:

"Removal of an individual asset of an asset pool will occur only if the related amount is material. The removal of a fully depreciated asset and the related accumulated depreciation from the BIF general ledger occurs in December. All other asset removals will occur, as needed, upon notification by the responsible division, generally DIRM or DOA."

The Accounting Bulletin stipulates that the "Corporation's managers are responsible for reviewing their operations and taking appropriate action to develop and implement required procedures".

DOF Response (4) – continued:

Furthermore, I recently issued a memorandum regarding “Confirmation of FDIC Internally Developed Software” to All Division and Office Directors, with an attached itemized listing of the completed internally developed software for each division or office.

The memorandum contains the following request to the Division/Office Directors.

“Please carefully review the “Confirmation of Internally Developed Software log” to ensure the information provided for your Division/Office is accurate:

1. Your division is the primary user of the software.
2. The estimated life or retirement date for the software is equal to or exceeds the date the software becomes fully depreciated. If the software is no longer in use, please note this on the log with the date it was discontinued. If you anticipate the software will be retired, or that you will discontinue use prior to the fully depreciated date, please provide an estimated retirement date in the “Comments / Estimated Retirement Date” column of the worksheet.”

DOF anticipates sending the “Confirmation of FDIC Internally Developed Software” to all of the Division and Office Directors again on October 1 of this year and in subsequent years.

If you have questions, please contact Joseph M. Naim, Assistant Director, at Ext. 62105.

CC: Chris Sale
Carol Heindel