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To Capitalize, or Not That is the Question!

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Consistent with the Statements of Financial Accounting Concepts (SFAC), U.S. generally accepted accounting principles (U.S. GAAP) require the capitalization of costs when a future benefit for the expenditure exists. For example, if a company purchases a building, the benefits of the building are expected to extend into the future. Therefore, the company would record an asset and depreciate the building over time. In some cases, such as the purchase of equipment, the decision to capitalize is straightforward. However, there are situations in which that decision is not as clear. Capitalization questions arise in multiple areas. The CPEA issued a report on accounting for self-constructed assets in May 2018. You can access that report [here](#). This report accumulates the professional guidance related to capitalization in the following areas:

- Repairs and maintenance
- Internally-developed intangible assets
- Patent defense costs
- Start-up costs
- Contract costs
- Advertising costs
- Website development costs

The Starting Point—What is an Asset?

While there is specific authoritative guidance that is applicable to certain transactions, the underlying issue is always “does the cost represent an asset or an expense.” The Financial Accounting Standards Board (FASB) defined the term, “asset,” in Statement of Financial Accounting Concepts 6, *Elements of Financial Statements*, as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Accordingly, an asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit already has occurred.

"Expenses," on the other hand, are defined in SFAC 6 as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."

To summarize, an "asset" represents a probable future benefit, while an "expense" represents a benefit already received. In each of the following situations, this relationship is evident in the conclusions related to capitalization versus expensing.

Repairs and Maintenance

The general guideline for accounting for PP&E expenditures made after acquisition is that, if the expenditures provide additional service potential beyond the initial estimated useful life, they should be capitalized; if they do not provide additional service potential, they should be expensed as incurred. Expenditures related to assets can increase future benefits in the following ways:

- An extension of the useful life of the asset
- An increase in the operating efficiency of the asset resulting in either an increase in the quantity of goods or services produced or a decrease in future operating costs
- An increase in the quality of the goods or services produced by the asset

Expenditures that cause any of these results should be capitalized initially and then expensed in future periods through depreciation, depletion, or amortization. Of course, materiality is an important factor in the practical application of this approach.

There are three methods used to record the cost of improvements:

- Substitution. The improvement can be recorded as both (1) a disposition of the old component and (2) the acquisition of the new component. This approach is conceptually appealing, but it is practical only if the original cost and accumulated depreciation of the old component can be separately identified.
- Capitalization of new cost. Another way to record an improvement is to include the cost of the improvement (net of any consideration received from the disposition of

the old component) as a debit to the related asset account, without removing the original cost and accumulated depreciation of the original component. This approach is acceptable only if the book value of the original component has been reduced to an immaterial amount through prior depreciation.

- Reduction of accumulated depreciation. Another way to increase an asset's book value is to leave the asset account unaltered but decrease its related accumulated depreciation. The argument for this method is that many improvements extend the useful life of an asset and are equivalent to a partial recovery of previously recorded depreciation. This approach produces the same book value as the capitalization of cost to the asset account. However, cost and accumulated depreciation amounts will differ under the two methods.

To illustrate the three methods, assume an entity is replacing its electrical wiring system with improved materials. The old wiring system has a book value of \$30,000 (cost of \$300,000 less accumulated depreciation of \$270,000). The new wiring has a cost of \$250,000.

First Method. Under the "substitution approach," the following entries would be made:

Dr. Wiring system	\$250,000	
Dr. Accumulated depreciation	\$270,000	
Dr. Loss on disposal of wiring system	\$30,000	
		Cr. Wiring system
		\$300,000
		Cr. Cash
		\$250,000

Book value of wiring system = \$250,000

Cost of wiring system = \$250,000

Accumulated depreciation of wiring system = \$0

Second Method. The "capitalization of new cost" method may not be an acceptable approach because the book value of the original wiring has not been reduced to an immaterial amount through prior depreciation. However, for illustrative purposes, the entries under this method would be as follows:

Dr. Wiring system	\$250,000	
		Cr. Cash
		\$250,000

Book value of wiring system = \$280,000 (\$300,000 + \$250,000 - \$270,000)

Cost of wiring system = \$550,000 (\$300,000 + \$250,000)

Accumulated depreciation of wiring system = \$270,000

Third Method. Under the “reduction of accumulated depreciation” method, the following entries would be made:

Dr. Accumulated depreciation	\$250,000	
		Cr. Cash
		\$250,000

Book value of the wiring system = \$280,000

Cost of wiring system = \$300,000

Accumulated depreciation of wiring system = \$20,000 (\$270,000 - \$250,000)

Internally-Developed Intangible Assets

According to FASB ASC 350, *Intangibles—Goodwill and Other*, costs to internally develop, maintain, or restore unidentifiable intangible assets (including goodwill) that have indeterminate lives, or that are inherent in a continuing business and related to the business as a whole, are recognized as expenses as incurred unless explicitly capitalizable under other U.S. GAAP (e.g., internally developed software).

Intangible assets acquired either individually or with a group of other assets outside of a business combination are initially recognized and measured based on their cost to the acquiring entity.

Patent Defense Costs

Questions about whether an entity may capitalize costs related to legal work in connection with patent applications or litigation sometimes arise. Because of the uncertainty associated with the successful development of intellectual property rights, legal costs incurred in connection with a patent application generally are expensed as incurred.

Paragraph 2260.03 of *AICPA Technical Questions and Answers* provides guidance on patent defense costs. According to the Q&A, the choice of capitalizing or expensing depends on the outcome of the lawsuit. FASB SFAC 6, indicates “. . . the legal and other costs of successfully defending a patent from infringement are ‘deferred legal costs’ only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent.” Therefore, if defense of the patent lawsuit is successful, costs may be capitalized to the extent of an evident increase in the value of the patent. Legal costs which relate to an unsuccessful outcome should be expensed.

Accordingly, capitalization of patent defense costs is appropriate only when a successful patent defense is likely to occur, and the value of the patent is expected to increase as a result. When the outcome of a patent defense is uncertain, U.S. GAAP does not address the accounting for patent costs under that circumstance. We recommend examining the likelihood of a positive outcome at the balance sheet date (and then up until issuance of the financial statements) to assess whether recording an asset makes sense in the circumstances. Disclosure of any patent costs that have been capitalized is recommended.

Often, defense of a patent maintains rather than increases the value of the patent, in which case defense costs should be expensed as incurred.

Start-Up Costs

Although companies refer to startup costs using varying terms, including pre-opening costs, pre-operating costs, organization costs, and startup costs, FASB ASC 720-15, *Other Expenses: Start-Up Costs*, refers to these costs only as startup costs. Under FASB ASC 720-15, startup activities include:

- Opening a new facility
- Introducing a new product or service
- Conducting business in a new territory
- Conducting business with an entirely new class of customers or beneficiary
- Initiating a new process in an existing facility
- Commencing some new operation

FASB ASC 720-15 also treats the costs of organizing a corporation or partnership as startup costs rather than as separate costs.

According to FASB ASC 720-15, a business must expense startup costs as incurred.

Contract Costs

FASB ASC 340-40, *Other Assets and Deferred Costs: Contracts with Customers*, addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of FASB ASC 606, *Revenue from Contracts with Customers*, should be capitalized. The two categories of costs addressed in FASB ASC 340-40 include: (a) costs to fulfill a contract and (b) costs to obtain a contract.

Costs to Fulfill a Contract

If there is other guidance in the FASB ASC that applies to the costs incurred to fulfill a contract within the scope of FASB ASC 606, that other guidance should be applied.

Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

FASB ASC	Type of Fulfillment Cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased or marketed

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. FASB ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

Costs to fulfill a contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or specific anticipated contract
- The costs incurred by the entity generate or enhance resources that will be used in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not performance obligations in and of themselves, but do contribute to the satisfaction of performance obligations)

Practice Note: Fulfillment costs incurred to presently satisfy a performance obligation should not be capitalized.

- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the contract and expected renewals will cover the costs)

If these fulfillment cost capitalization criteria are met, the fulfillment costs must be capitalized.

Costs to Obtain a Contract

The incremental costs to obtain a specific contract within the scope of FASB ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission that is contingent on obtaining a contract.

The incremental costs to obtain a contract should be capitalized if the entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less. The amortization period includes anticipated renewals in some cases (depending on whether commissions commensurate with initial contract are needed).

The costs to obtain a contract within the scope of FASB ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

Advertising Costs

According to FASB ASC 720-35, *Other Expenses: Advertising Costs*, an entity must recognize advertising costs as an expense when either:

- The entity incurs the cost
- The advertising first takes place

An entity's accounting policy must reflect one of these two options and must apply the selected method consistently to similar types of advertising activities.

Practice Note: An entity may pay for advertising after the entity recognizes the revenue from sales that the advertising helped to generate. For example, an entity may agree to a cooperative advertising arrangement and reimburse a reseller's advertising costs. Under this arrangement, the entity recognizes revenue upon sales that result from the advertising. When the entity recognizes the revenue, therefore, it must accrue the estimated cost of the advertising as an expense and the related obligation as a liability.

An entity may account for promotional materials, such as printed brochures and catalogues, as prepaid supplies. When the entity no longer owns these materials or expects to use them, it must recognize the previously deferred cost as an advertising expense in accordance with FASB 720-35.

In order for an entity to capitalize advertising costs as an asset under the guidance in FASB ASC 340-20, *Other Assets and Deferred Costs: Capitalized Advertising Costs*, the entity must have demonstrable and reliable evidence of a direct connection between the cost of the advertising and the expected future benefits from the advertising. Accordingly, only narrow conditions permit capitalization of direct-response advertising costs.

Website Development Costs

The accounting treatment for costs incurred by an entity in developing a website depends on the development stage. There are five development stages:

- Planning stage
- Website application and infrastructure development stage
- Graphics development stage
- Content development stage
- Operating stage

During the planning stage, all costs are expensed as incurred. During the later stages of website development, costs are either expensed as incurred or capitalized depending on the facts and circumstances.

The costs incurred during the website application and development stage are accounted for as follows:

- Generally, an entity must follow the guidance in FASB ASC 350-40, *Intangibles—Goodwill and Other: Internal-Use Software*, to account for costs associated with software used to run a website. If, however, an entity currently has a plan (or is in the process of creating one) to offer the software for sale to external third parties, the entity must follow the guidance provided for software to be sold, leased, or marketed in FASB ASC 985-20, *Software: Costs of Software to Be Sold, Leased, or Marketed*. In particular, FASB ASC 985-20 requires that the costs of developing software be expensed as incurred until the entity is able to conclude that it is possible to create the software in a way that achieves the design specifications.
- Fees incurred for website hosting are expensed over the term in which an Internet service provider grants Internet access. Such fees include specific, recurring payments to an Internet service provider in exchange for accommodating the website on its server.
- In general, an entity must capitalize costs incurred during the website application and development stage to acquire or internally develop software tools. However, an entity must expense costs if the tools are utilized by the entity in research and development activities and the tools either (1) have no other future use; or (2) are produced within the company and are part of a trial program or are utilized for a particular research and development activity.
- Costs incurred to acquire and register an Internet domain are capitalized.

Graphics are an element of software. The accounting for the costs of creating preliminary graphics depends on whether the graphics are for inclusion in software that is to be used internally or sold to external third parties. For the costs of graphics related to internal-use

software, an entity must follow the guidance in FASB 350-40. For the costs of graphics related to software marketed to third parties, an entity must use the guidance in FASB 985-20.

If an entity modifies a website after the initial launch, the entity must perform an assessment to determine if the modifications were performed to maintain the website or improve the website.

An entity must account for costs incurred in the content development stage of a website as follows:

- An entity must expense all costs to enter content into a website in the period that the costs are incurred
- An entity must capitalize costs incurred for software employed to integrate a database with a website
- An entity must expense data conversion costs in the period that the costs are incurred

An entity must recognize costs of operating a website in the same manner as it recognizes costs for any other operations. Costs for operating a website must be expensed as incurred.

FASB ASC 720-35 provides that costs for registering a website with an Internet search engine qualify as advertising costs and must be expensed as an entity incurs them.

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