elliott davis

accounting for core processing system conversion and other related costs

Choosing to change core providers is a huge decision. Unless the financial institution is a de novo, a current core system is already in operation. However, as technology and customer expectations are rapidly changing, institutions may find that their current core provider no longer suits their needs. An entity might decide to undergo a core processing system conversion for several reasons, each aimed at enhancing efficiency, cost reduction, competitiveness, user experience, compliance and regulation and overall business performance. The core processing system conversion process involves several steps to ensure accurate data transfer, compliance, and continued financial integrity. The entity may incur various kinds of costs at each step.

accounting treatment

The accounting treatment for core conversion costs varies based on the nature of the costs, and at what stage of the project the costs are incurred. Because the accounting implications may be material to the financial statements, determining whether to expense or capitalize certain costs in connection with a core processing system conversion is essential. Accounting standards under ASC 350-40, *Intangibles – Goodwill and Other – Internal-Use Software* provide accounting guidance for the costs to develop or obtain software for internal use. This guidance defines three stages in the development/acquisition of the internal-use software. Each stage has specific accounting implications, and entities must follow the guidance to determine which costs can be capitalized and which should be expensed to ensure compliance with ASC 350-40 and accurate financial reporting.

1. PRELIMINARY PROJECT STAGE

This phase includes the early stages of the project during which the entity is exploring its technological needs and various alternatives. All costs incurred during this stage should be expensed as incurred. Examples of activities in the preliminary project include:

- → Resource Decisions Deciding how to allocate resources, such as whether to develop a new payroll system or fix an existing one.
- → Defining Requirements Determining what functions the software needs to perform and the corresponding technical requirements.
- → Vendor Demos Inviting vendors to demonstrate their software solutions.
- → Exploring Options Considering whether to build the software in-house or buy it and choosing the best platform (mainframe or client-server).
- → Technology Check Ensuring the necessary technology is available.
- → Selecting a Vendor Choosing a vendor if purchasing software.
- → Hiring Consultants Engaging consultants for help with development or installation.

2. APPLICATION TO DEVELOPMENT STAGE

Capitalization of qualifying costs at this stage should begin when both of the following occur:

- → The preliminary project stage is completed, and
- → The entity commits to funding the project, it is probable the project will be completed, and the software will be used to perform the intended function.

This phase consists of designing, coding and testing the software and hardware installation. Direct costs incurred in this phase should be capitalized.

Examples of costs include: fees paid to a third party for software development, amounts paid to acquire software, and payroll costs incurred for employees directly associated with the development/acquisition of the software (those involved in coding/testing). Certain data conversion costs may also be capitalized if they are related to developing and obtaining software used to access or convert old data to the new systems. All other data conversion costs should be expensed as incurred. Other indirect costs such as training costs, general, and administrative costs should be expensed as incurred.

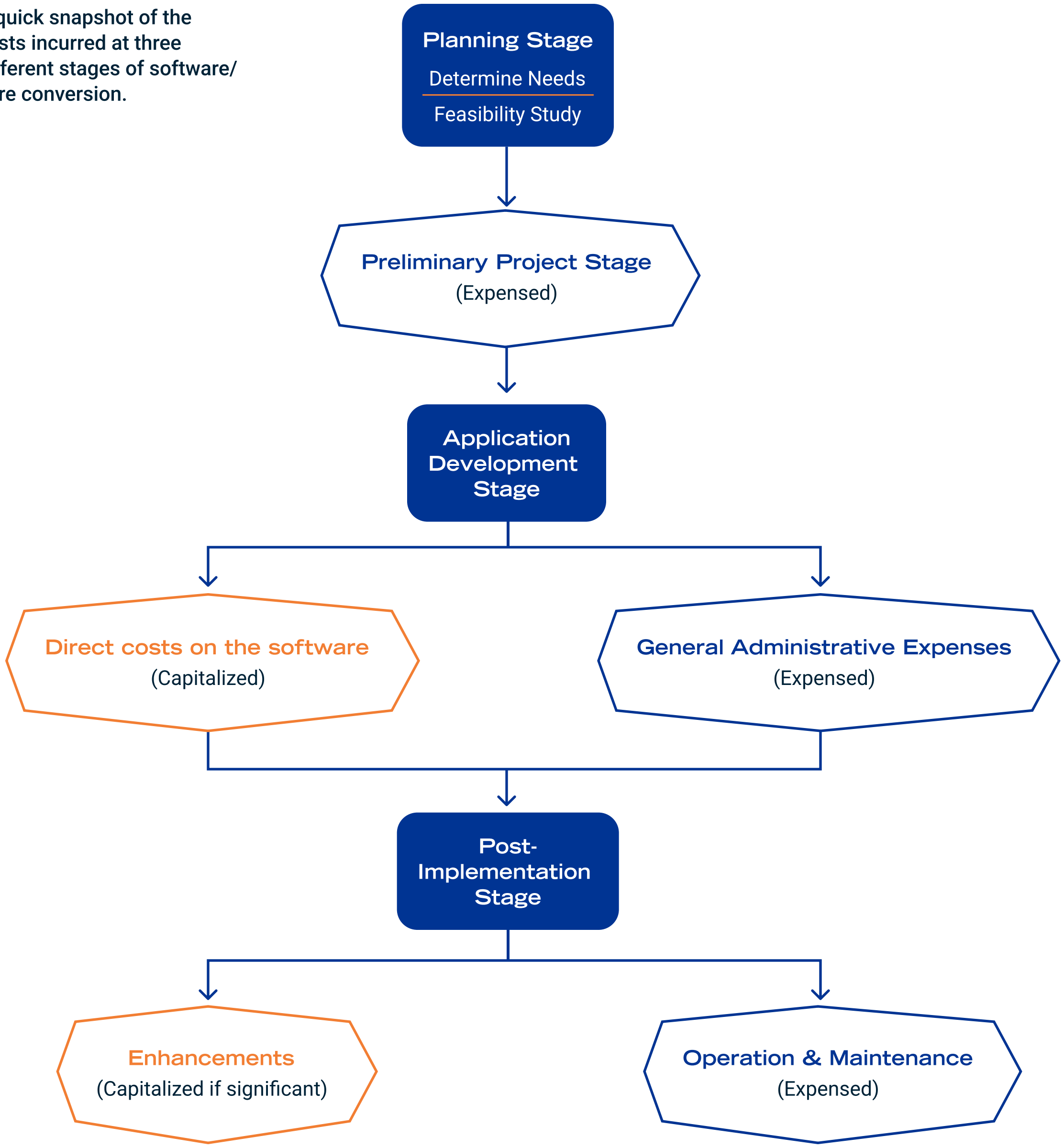
3. POST-IMPLEMENTATION STAGE

This phase begins when the software is ready for its intended use. Activities during this stage typically include the implementation, training, and maintenance of the software. Expenses incurred during this stage may include training costs, developing user manuals/online resources, minor tweaks or enhancements made based on the feedback received, technical support, performance monitoring, and maintenance. These are generally expensed as incurred.

recognition of capitalized costs

The capitalized amounts should be amortized over the estimated useful life of the new software, typically using a straight-line method. Amortization should commence when the software is ready for its intended use, even if it has not yet been placed in service.

A quick snapshot of the costs incurred at three different stages of software/core conversion.


Planning Stage
Determine Needs
Feasibility Study
Preliminary Project Stage
(Expensed)
Application Development Stage
Direct costs on the software
(Capitalized)
General Administrative Expenses
(Expensed)
Post-Implementation Stage
Enhancements
(Capitalized if significant)
Operation & Maintenance
(Expensed)

accounting considerations related to other elements of system conversions

In addition to software development costs, management should consider other factors which may impact financial reporting related to system conversions and carefully evaluate the accounting implications for items such as the following:

1. DECONVERSION OR TERMINATION COSTS

Entities may be faced with contract termination costs or decommissioning expenses (costs for uninstalling or removing the old software and related hardware). Guidance in ASC 420, *Exit or Disposal Cost Obligations* clarifies when to recognize liabilities associated with terminating contracts. Contract termination costs may include the cost to terminate early as well as ongoing costs that will continue to be incurred for the remaining term of the contract. In the case of early termination costs, a liability is recognized when the contract is officially terminated, either by giving notice as specified in the contract or through negotiation with the counterparty. Regarding ongoing costs, a liability for costs that will be incurred without economic benefit is recognized on the cease-use date.

2. DATA CONVERSION COSTS

Data conversion costs, such as employee time spent physically converting data, should be expensed as incurred even during the application development stage. However, as stated in the *guidance ASC 350, Intangibles – Goodwill and Other – Internal-Use Software*, if the costs are incurred to develop or obtain the software that allows for access or conversion of old data by new systems, such costs must be capitalized, as the new software may not be able to function as intended until the data has been migrated from the old software.

3. INCENTIVES

Incentives may include any upfront payments to the entity, reduced or no payments for a certain period of time, or credits to be used for a certain period of time or for certain future purchases or payments. Depending upon their nature, incentives can either reduce the capitalized costs related to a new system or be recognized as a reduction in operating expenses.

The performance obligation enumerated in many contracts is fulfilled over a period of time. In accordance with revenue recognition guidance in ASC 606, *Revenues from Contracts with Customers*, performance obligations satisfied over time require revenue to be recognized over time by measuring the progress toward complete satisfaction of the performance obligation. Entities should apply a reasonable method to measure progress toward satisfying performance obligations, such as the straight-line method. Upfront incentives, such as cash payments to induce entering into an agreement with a vendor or terminating an existing contract may be refundable or nonrefundable.

Accounting guidance related to consideration received from a vendor under ASC 705-20, *Accounting for Consideration Received from Vendors*, does not distinguish between refundable and nonrefundable. While terms may differ across various contracts, upfront incentives should be viewed as an integral part of the overall contract and should be evaluated against the performance obligations within a given contract. If the performance obligations of a contract are satisfied over a period of time, as is often the case, these upfront incentives should be deferred and recognized over the life of the contract.

When these incentives are directly tied to the purchase price or costs incurred for the new system or when they are linked to specific implementation expenses, then these incentives are accounted for as a reduction of the amount capitalized. Vendors may also offer incentive payments to help cover costs for terminating an existing contract. Entering into one contract and terminating another should be treated as separate events and accounted for individually.

4. BILLING CREDITS AND REBATES

Billing credits/rebates relate to financial incentives or other adjustments. Vendors may also offer billing credits or rebates during the transition to a new core system. These may be contingent on the volume of services or purchases or the length of the contract term. Guidance in ASC 705 indicates when a business receives a rebate or refund based on a binding agreement that requires meeting certain purchase levels or remaining a customer for a specified time, the rebate or refund should be recognized as a reduction in the cost of sales. Billing credits/rebates should be recognized as the entity makes progress toward satisfying the performance obligation. If the amount is not likely to be earned or cannot be reasonably estimated, recognition should occur only when specific milestones are reached.

5. CONSULTANT NEGOTIATION COSTS

An entity may hire a consultant to negotiate the fee for a new core processing system contract. The fee charged by a consultant is commonly a percentage of the total cost savings realized over the contract term and is paid in one lump sum when the contract is signed. These negotiation costs may not necessarily result in the acquisition of a new system. Hence, these costs must not be capitalized. Some agreements stipulate services to be rendered in the future. In those circumstances, recognition as a prepaid asset may be appropriate. Services rendered by a consultant prior to acquiring software for internal use, such as the core processing system, should be expensed as incurred as these costs are for activities having occurred in the preliminary project stage in accordance with ASC 350.

When a negotiation agreement consists of both upfront and ongoing services, entities should determine the fair value of each and allocate the relative fair value between upfront and ongoing services to determine the appropriate accounting treatment. In many cases, ongoing services represent a much smaller portion of the total contract value compared to the upfront services.

6. HOSTING ARRANGEMENTS

New core accounting system contracts may include hosting arrangements, such as cloud computing or software-as-a-service (SaaS), through which the financial institution accesses software remotely without owning it. A cloud computing arrangement (CCA) includes a software license if:

- → The entity can take possession of the software anytime during the hosting period without significant penalties, and;
- → The entity can run the software on its own hardware or have it hosted by an unrelated third party.

If a CCA includes a software license, it should be treated as an asset. Any outstanding software license fees should be recognized as a liability on the acquisition date.

If the arrangement does not meet the software license criteria, it's considered a service contract, and costs should be treated similarly to internal use software.

Implementation costs capitalized as part of a hosting arrangement should be amortized over the contract term, which includes:

- → The fixed noncancelable term.
- → Any options to extend that are reasonably certain to be exercised.
- → Any options to terminate that are reasonably certain not to be exercised.

7. UPGRADES AND ENHANCEMENTS

Entities may also implement modifications to add new functionalities to existing software, enabling it to perform tasks it could not previously accomplish. Implementing these changes typically requires developing new software specifications and potentially revising existing ones. Such costs may be either internal or external, and are described in more detail below:

INTERNAL COSTS

Internal costs incurred for upgrades and enhancements should be expensed or capitalized depending upon stages mentioned above. Internal costs incurred for maintenance shall be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

EXTERNAL COSTS

External costs for specified upgrades and enhancements can be either capitalized or expensed depending upon the stages mentioned above. In the case of combined contracts, if maintenance services are bundled with specified upgrades or enhancements in one contract, costs must be allocated between the different components. Costs related to maintenance, unspecified upgrades, or combined contracts that include maintenance and unspecified upgrades should be expensed over the contract period. This is typically done on a straight-line basis, unless a different method better reflects the timing and nature of the services received.

elliott davis can help your management team navigate the accounting issues presented in a core system conversion

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