

# FASB MODERNIZES THE ACCOUNTING FOR INTERNAL-USE SOFTWARE COSTS

November 2025

## Overview

In September 2025, the Financial Accounting Standard Board (FASB) issued ASU 2025-06, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*, with the aim of modernizing the guidance for internal-use software development costs. ASU 2025-06 eliminates outdated, prescriptive guidance tied to sequential software development stages and introduces a principles-based approach that better reflects modern, iterative development methods. Under the amended guidance, entities are required to capitalize internal-use software costs once management has authorized and committed to funding and it is probable the project will be completed and the software will be used as intended, provided there is no significant development uncertainty. ASU 2025-06 also integrates website development costs into the internal-use software framework and provides flexible transition options for adoption.

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## 1. BACKGROUND

The existing guidance for the capitalization of internal-use software costs, as codified in Accounting Standards Codification (ASC) 350-40, *Intangibles – Goodwill and Other— Internal-Use Software*, was issued in 1998 and uses rigid “project stages” (i.e., preliminary, application development and postimplementation-operation). These project stages do not align well with modern, agile development practices, which are iterative and lack clear delineation between stages. Stakeholders—including preparers, investors and practitioners—have repeatedly expressed concerns over operability challenges and diversity in practice, especially when iterative development methods are used. Feedback received on the FASB’s 2021 Agenda Consultation Invitation to Comment underscored that the accounting for software costs deserved heightened attention, which prompted the FASB to prioritize improvements to internal-use software accounting and resulted in the issuance of ASU 2025-06.

## 2. SCOPE

The amendments in ASU 2025-06 apply to all entities subject to ASC 350-40, including those accounting for website development costs under ASC 350-50, *Intangibles – Goodwill and Other— Website Development Costs*. The changes do not affect software costs subject to ASC 985-20, *Software—Costs of Software to Be Sold, Leased, or Marketed*.

## 3. KEY AMENDMENTS

### 3.1 Removal of project stage model

One of the most impactful changes resulting from the issuance of ASU 2025-06 is the removal of references to prescriptive software development stages. Previously, entities had to distinguish between the preliminary project stage, application development stage and postimplementation - operation stage. While these distinctions were useful under the traditional, sequential “waterfall” development methods, in recent years development models have shifted to incremental and iterative models, such as the “agile” development methods. Under these models, the distinctions between the preliminary stage and the application development stage are often blurred, leading to challenges and inconsistencies in practice when accounting for software development costs. The new guidance removes the need to differentiate between project stages, making the rules neutral to development methodology and more operable for iterative environments.

### 3.2 New capitalization threshold



#### ASC 350-40-25-12

Capitalization of costs shall begin when both of the following occur:

- a. Subparagraph superseded by Accounting Standards Update No. 2025-06.
- b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project. Examples of authorization and commitment to funding a computer software project include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.
- c. It is probable that the project will be completed and the software will be used to perform the function intended (referred to as the probable-to-complete recognition threshold). In evaluating whether the probable-to-complete recognition threshold has been met, an entity shall assess whether there is significant uncertainty associated with the development activities of the software (referred to as significant development uncertainty) in accordance with paragraph 350-40-25-12A.

Under the new guidance, entities will be required to start capitalizing internal-use software costs when both of the following occur:

- Management has authorized and committed to funding the software project.
- It is probable that the project will be completed and the software will be used to perform the function intended (referred to as the “probable-to-complete recognition threshold”).

To satisfy the first criterion, management possessing the relevant authority must formally or informally approve and allocate funding for a computer software initiative. For example, a signed contract, a board resolution or an approved budget allocation would all qualify as evidence of management commitment. When purchasing an existing software that requires relatively minor customization of the underlying software, such as an Enterprise Resource Planning system, we expect the evaluation of whether management authorization has been obtained and funding has been committed to be the primary driver for determining when costs can be capitalized. The following example from ASC 350-40 illustrates this point.



### **Example 3-1: Implementation and customization of an Enterprise Resource Planning system (ASC 350-40-55-5 through 55-8)**

On February 1, 20X3, a professional services company starts internal discussions to transform its information technology by implementing an enterprise resource planning system to support finance, human resources, accounting, and client relationships.

After researching different solutions and performing its due diligence procedures, management executes a contract with a third party on August 1, 20X3, to implement and customize a hybrid solution that offers on-premises software and cloud computing services for the enterprise resource planning system. Within this solution, the third party offers different functionality and features, and the company will have to make customization decisions throughout the development process to select which functionality and features it wants included.

The company assesses whether the internal and external costs to implement and customize the enterprise resource planning system meet the capitalization requirements in paragraphs 350-40-25-12 through 25-12A, as follows:

- a. As part of its assessment under paragraph 350-40-25-12(c), the company evaluates whether there is significant development uncertainty in accordance with paragraph 350-40-25-12A. As of August 1, 20X3, the company determines that:
  1. It has identified the significant performance requirements and does not expect to continue to substantially revise those requirements because the only expected customization is selecting from existing functionality and features.
  2. The software being developed does not have technological innovations or novel, unique, or unproven functions or features because the company has selected a developed solution.

Therefore, as of August 1, 20X3, the company determines that significant development uncertainty does not exist.
- b. The company evaluates the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing software costs:
  1. The company determines that management authorized and committed to funding the software project on August 1, 20X3, when it executed the contract with the third party.
  2. Considering all other relevant facts and circumstances (for example, the company has engaged an established and experienced third party to implement and customize the software), as of August 1, 20X3, the company determines that it is probable that the software project will be completed and the software will be used to perform the function intended.

As a result, on August 1, 20X3, the company determines that the capitalization requirements in paragraphs 350-40-25-12 through 25-12A are met, and it begins capitalizing eligible software costs, including those related to implementation and customization of the on-premises software license and those related to implementation of the cloud computing service features of the hybrid solution.

The second criterion for capitalizing costs requires an assessment of whether a project meets the probable-to-complete recognition threshold, which is based on whether it is probable the project will be completed and the software will be used to perform the function intended. Probable is defined as “the future event or events are likely to occur.” When evaluating the probable-to-complete recognition threshold, entities should assess all relevant facts and circumstances in determining whether significant development uncertainty exists, including whether the significant performance requirements of the software have been identified (see [Section 3.3](#)).

If, at any point, it becomes no longer probable that the project will be completed and used as intended—due to technical setbacks, budget cuts or strategic shifts—capitalization must cease, and the impairment guidance in ASC 350-40-35-1 through 35-3 should be applied to any existing balances. As long as it remains probable that the software will be completed and placed into service, it continues to be evaluated for impairment as part of the related asset group in accordance with the guidance in ASC 360.

The ASU does not change when internal-use software capitalization ceases, which continues to be when the software is complete and ready for its intended use.

When evaluating whether costs qualify for capitalization, paragraph BC61 of ASU 2025-06 refers to a software project as the unit of account for evaluating the capitalization criteria in ASC 350-40-25-12. However, the FASB did not define what qualifies as a software project. As a result, entities should continue to apply judgment in determining what constitutes a software project on the basis of their specific facts and circumstances.

### 3.2.1 Evaluating significant development uncertainty



#### ASC 350-40-25-12A

If significant development uncertainty exists, the probable-to-complete recognition threshold in paragraph 350-40-25-12(c) is not met until that significant development uncertainty has been resolved. Significant development uncertainty exists if either of the following factors is present:

- a. The software being developed has technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to those technological innovations, functions, or features, if identified, has not been resolved through coding and testing.
- b. The significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised.

For some types of software projects, the assessment of whether significant development uncertainty exists will be straightforward, such as illustrated in Example 1 (see paragraphs 350-40-55-5 through 55-8). For other types of software projects, the assessment will be more complex, such as illustrated in Example 3 (see paragraphs 350-40-55-13 through 55-17). If significant development uncertainty does not exist or if there was significant development uncertainty that has been resolved, an entity shall evaluate the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing costs.

As part of the evaluation of the probable-to-complete recognition threshold, ASU 2025-06 introduces a new requirement for entities to evaluate whether there is significant uncertainty associated with the development activities of the software. Capitalization cannot begin until such uncertainty is resolved as a

project is not deemed to be probable of completion if significant development uncertainty exists. ASC 350-40-25-12A identifies two key factors that indicate significant development uncertainty:

- **Novel, Unique or Unproven Software.** If the software being developed includes technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to these has not been resolved through coding and testing, capitalization must be deferred.
- **Significant Performance Requirements.** If the significant performance requirements of the software have not been identified, or if they continue to be substantially revised, the project does not meet the capitalization threshold.

This approach ensures that only costs associated with projects that are likely to succeed and deliver the intended functionality are capitalized, while costs incurred during periods of uncertainty are expensed.

These factors closely align with the external-use software guidance in ASC 985-20. While the FASB believes that most entities are unlikely to see a significant change in the overall amount of capitalized software costs (see paragraph BC4 of ASU 2025-06) for software developed to be provided via cloud computing arrangements, the update may result in decreased capitalization, aligning more closely with the accounting for software sold via on-premises licenses. This change is intended to improve consistency and comparability for investors and analysts.

### 3.2.1.1 Novel, unique or unproven software

The first factor that signals “significant development uncertainty” under ASU 2025-06 is whether the software being developed has technological innovations or novel, unique, or unproven functions or features that have not been resolved through coding and testing.

The FASB intentionally chose this language to align with similar concepts in the guidance for external-use software, where “high-risk development issues” are flagged as requiring careful consideration. However, rather than introducing new terminology, ASU 2025-06 uses the same language as that used in ASC 985-20. Software is considered novel or unproven if it incorporates new technology, unique functionalities, or features that have not been previously developed or tested. For example, a company developing a new artificial intelligence engine, a blockchain-based ledger or a radically new user interface would likely be dealing with novel or unproven software.

The presence of novel or unproven elements means there is a higher risk that the software project may not be completed as intended or may not function as expected. As a result, costs incurred during this period of uncertainty should be expensed, not capitalized. Only after the uncertainty is resolved—demonstrated through successful coding and testing—can an entity begin to capitalize eligible costs.

Additionally, ASU 2025-06 specifies that uncertainty related to novel or unproven software must be resolved through coding and testing. For instance, if a company is developing a new feature that has never been implemented before, it must demonstrate through actual development and testing that the feature works as intended before capitalizing further costs. This requirement is similar to the concept of “technological feasibility” in external-use software guidance but tailored for internal-use scenarios.



#### Example 3-2: Development of a novel technology (ASC 350-40-55-13 through 55-17)

On January 1, 20X1, a software development company starts discussions to develop software with novel functionality.

On February 1, 20X1, management completes its due diligence procedures, approves a budget to internally develop the software, and allocates an internal development team to start developing the novel software. At the time that the company started discussions and management approved a budget, the software still had novel functionality.

On March 1, 20X3, the company resolves the uncertainty related to the novel functionality through coding and testing. Additionally, on March 1, 20X3, the company determines that it does not expect substantial

changes to the identified significant performance requirements (the significant functions and features) included in the software. On April 1, 20X3, the company determines that all substantial testing is completed.

The company assesses whether the internal and external costs to develop the software meet the capitalization requirements in paragraphs 350-40-25-12 through 25-12A, as follows:

- a. As part of its assessment under paragraph 350-40-25-12(c), the company evaluates whether there is significant development uncertainty in accordance with paragraph 350-40-25-12A. As of February 1, 20X1, the company determines that:
  1. It has not yet identified the significant performance requirements.
  2. The software being developed has novel functionality and that functionality has not been resolved through coding and testing.

Therefore, as of February 1, 20X1, the company determines that significant development uncertainty exists and, in accordance with paragraph 350-40-25-12A, the software project does not meet the requirements to begin capitalizing software costs in paragraph 350-40-25-12(c).

- b. As of March 1, 20X3, the company determines that:
  1. It has identified the significant performance requirements and does not expect to continue to substantially revise those requirements.
  2. The uncertainty related to the novel functionality has been resolved through coding and testing.

Therefore, as of March 1, 20X3, the company determines that significant development uncertainty has been resolved.

- c. As of March 1, 20X3, the company evaluates the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing software costs:
  1. The company determines that management authorized and committed to funding the software project on February 1, 20X1, when it approved a budget and allocated an internal development team.
  2. Considering all other relevant facts and circumstances, as of March 1, 20X3, the company determines that it is probable that the software project will be completed and the software will be used to perform the function intended.

As a result, on March 1, 20X3, the company determines that the capitalization requirements in paragraphs 350-40-25-12 through 25-12A are met, and it begins capitalizing eligible software costs. On April 1, 20X3, the company determines that the software project is substantially complete and ready for its intended use because all substantial testing has been completed. Therefore, the company ceases capitalizing eligible software costs on April 1, 20X3, in accordance with paragraph 350-40-25-14.

### 3.2.1.2 Significant performance requirements

The second factor indicating there is significant development uncertainty is when the significant performance requirements of the software have not been identified, or the identified requirements continue to be substantially revised.

Performance requirements are defined as what an entity needs the software to do—essentially, the functions or features that are critical to the software’s intended use.

The FASB included this factor to reflect the reality of modern software development, especially in agile or iterative environments, where requirements may evolve over time. The guidance does not require that all performance requirements be finalized before capitalization, but it does require that the significant ones are identified and not subject to ongoing, substantial revision.

If significant performance requirements are not identified, or if they are continually substantially revised, there is a risk that the software project may not deliver the intended functionality or may require substantial rework. In such cases, the future economic benefit is uncertain, and costs should be expensed until the uncertainty is resolved.

This approach balances the need for flexibility in development with the need for reliable financial reporting. It allows entities to capitalize costs once the major requirements are clear and stable, even if minor details continue to evolve.

The FASB deliberately left the determination of “significance” to management judgment, recognizing that each software project is unique. Entities should focus on requirements that are critical to the software’s core functionality or business purpose in making this determination.



### **Example 3-3: Development of a mobile application (ASC 350-40-55-9 through 55-12)**

A company is in the process of internally developing X-Crowd, which is a mobile application that will allow users to see how crowded a restaurant or store is on the basis of a user’s real-time input. An internet connection is required to be able to access the application.

On February 1, 20X1, management approved funding for internal development of the application. However, the company has not yet identified what functions and features would be included in the application. Through November 30, 20X1, the company continues to develop the functions and features of the application, including getting feedback on preliminary product versions from user groups and modifying the development of those functions and features to incorporate the feedback. On December 1, 20X1, management determines that it has identified the significant performance requirements (the significant functions and features it needs the application to have), and it does not anticipate substantial changes to those requirements. Throughout the development of X-Crowd, management determines that the application does not have technological innovations or novel, unique, or unproven functions or features.

The company assesses whether the internal and external costs to develop the application meet the capitalization requirements in paragraphs 350-40-25-12 through 25-12A, as follows:

- a. As part of its assessment under paragraph 350-40-25-12(c), the company evaluates whether there is significant development uncertainty in accordance with paragraph 350-40-25-12A. As of February 1, 20X1, the company determines that:
  1. It has not yet identified the significant performance requirements.
  2. The software being developed does not have technological innovations or novel, unique, or unproven functions or features.

Therefore, as of February 1, 20X1, the company determines that significant development uncertainty exists and, in accordance with paragraph 350-40-25-12A, the software project does not meet the requirements to begin capitalizing software costs in paragraph 350-40-25-12(c).

- b. As of December 1, 20X1, the company determines that:
  1. It has identified the significant performance requirements and does not expect to continue to substantially revise those requirements.
  2. The software being developed does not have technological innovations or novel, unique, or unproven functions or features.

Therefore, as of December 1, 20X1, the company determines that significant development uncertainty has been resolved.

- c. As of December 1, 20X1, the company evaluates the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing software costs:

1. The company determines that management authorized and committed to funding the software project on February 1, 20X1, when it approved funding for internal development of the application.
2. Considering all other relevant facts and circumstances, as of December 1, 20X1, the company determines that it is probable that the software project will be completed and the software will be used to perform the function intended.

As a result, on December 1, 20X1, the company determines that the capitalization requirements in paragraphs 350-40-25-12 through 25-12A are met, and it begins capitalizing eligible software costs.

### 3.3 Website development costs

ASU 2025-06 supersedes ASC 350-50, incorporating the recognition requirements for website-specific development costs into ASC 350-40. This change reflects the reality that websites are now often interfaces to underlying software, and their development should be accounted for in the same way as other internal-use software projects. The following example illustrates the application of the new guidance to website development costs.



#### **Example 3-4: Development of a website (ASC 350-40-55-18 through 55-8)**

An animal rescue organization starts discussions on June 15, 20X5, to develop a website that will be used to share information with users of the organization, including hours of operation, contact details, animals available for adoption, and standard adoption procedures.

After researching different website developers and performing its due diligence procedures, management executes a contract with a third party on August 1, 20X5, to develop a website for the organization. The third party is an established website developer and offers different templates that the organization can use to create its website. In addition to website development fees paid to the third party, the organization incurs costs:

- a. To obtain and register an internet domain
- b. To input content into the website
- c. To develop initial graphics for the website
- d. To register the website with internet search engines
- e. For ongoing website hosting fees.

The organization assesses whether the internal and external costs to develop the website meet the capitalization requirements in paragraphs 350-40-25-12 through 25-12A, as follows:

- a. As part of its assessment under paragraph 350-40-25-12(c), the organization evaluates whether there is significant development uncertainty in accordance with paragraph 350-40-25-12A. As of August 1, 20X5, the organization determines that:
  1. It has identified the significant performance requirements and does not expect to continue to substantially revise those requirements because the website will be created from existing templates that the organization can use to share the information described in paragraph 350-40-55-18.
  2. The website being developed does not have technological innovations or novel, unique, or unproven functions or features because it will be developed from existing templates.

Therefore, as of August 1, 20X5, the organization determines that significant development uncertainty does not exist.

- b. The organization evaluates the requirements in paragraph 350-40-25-12 to determine when to begin capitalizing costs:
  - 1. The organization determines that management authorized and committed to funding the development of the website on August 1, 20X5, when it executed the contract with the third party.
  - 2. Considering all other relevant facts and circumstances (for example, the organization has engaged an established and experienced third party to develop the website), as of August 1, 20X5, the organization determines that it is probable that the project will be completed and the website will be used to perform the function intended.

As a result, on August 1, 20X5, the organization determines that the capitalization requirements in paragraphs 350-40-25-12 through 25-12A are met, and it begins capitalizing eligible costs. In evaluating which costs are eligible for capitalization, the organization determines the following:

- a. Fees paid to the third party for services to develop the website are evaluated for capitalization in accordance with paragraph 350-40-30-1.
- b. Costs incurred to obtain and register the internet domain are evaluated for capitalization in accordance with paragraph 350-40-25-17J.
- c. Costs incurred to input content into the website are expensed as incurred in accordance with paragraph 350-40-25-17G.
- d. Costs incurred to develop initial graphics for the website are evaluated for capitalization in accordance with paragraph 350-40-25-17H.
- e. Costs incurred to register the website with internet search engines are expensed as incurred in accordance with paragraph 350-40-25-17I.
- f. Ongoing website hosting fees are expensed over the period of benefit in accordance with paragraph 350-40-25-17F.

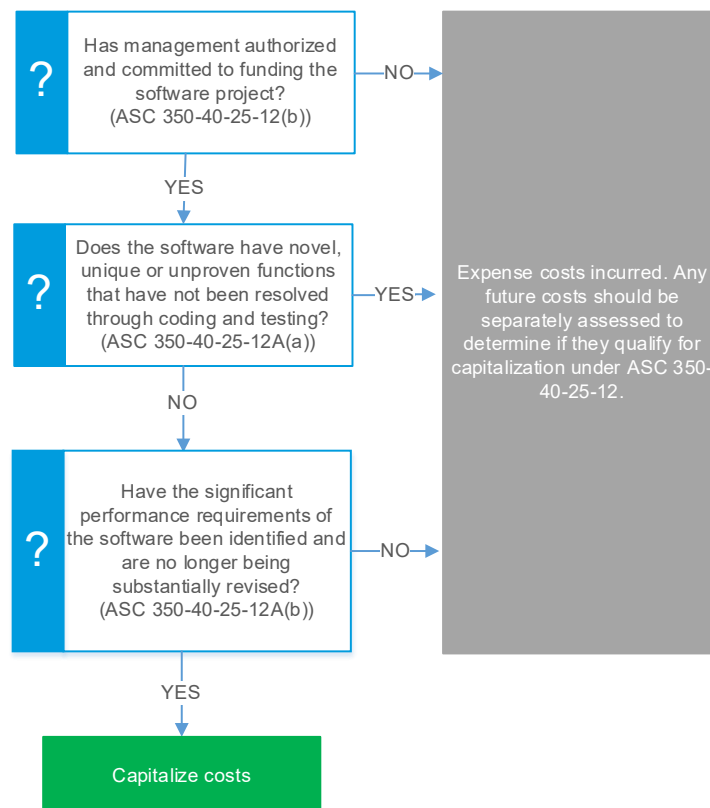
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### 3.4 Disclosure requirements

ASU 225-06 clarifies that all capitalized internal-use software costs must be disclosed in accordance with ASC 360-10, *Property, Plant, and Equipment—Overall*, regardless of how those costs are presented in the financial statements. At the same time, it relieves entities from the intangibles disclosures required by ASC 350-30-50-1 through 50-3 for capitalized internal-use software costs. No additional incremental disclosures are required, as the FASB determined that current requirements are sufficient and that further disclosures would not provide significant incremental benefits relative to their cost.

### 3.5 Flowchart

The following flowchart illustrates the application of the capitalization criteria in ASC 350-40-25-12 through ASC 350-40-25-12A.



## 4. TRANSITION REQUIREMENTS AND EFFECTIVE DATE

The amendments under ASU 2025-06 apply to annual periods beginning after December 15, 2027, including interim periods within them. Early adoption is allowed at the start of any annual reporting period. Entities may choose from three transition approaches:

- **Prospective.** Apply the new guidance to new costs incurred for all projects, including in process projects, after the date of adoption.
- **Modified.** Apply the new guidance to new costs incurred for all projects after the date of adoption but derecognize capitalized costs for in-process projects that do not meet the new capitalization requirements, with a cumulative-effect adjustment to opening retained earnings.
- **Retrospective.** Recast comparative periods and recognize a cumulative-effect adjustment to opening retained earnings.

This flexibility allows entities to select the transition method that best fits their circumstances and data availability.

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