Statutory Issue Paper No. 17

Preoperating and Research and Development Costs

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 17

Type of Issue:
Common Area

SUMMARY OF ISSUE

is consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity's "*ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.*"

6. FAS 2 requires research and development costs (e.g., costs related to the development of an insurance product providing a new form of coverage or modifications to an existing insurance product) to be expensed as incurred. FAS 7 specifies that the accounting of the cost of a development stage enterprise should be no different than the accounting for similar costs of a mature enterprise. FAS 7 requires that the recoverability of costs incurred by a development stage enterprise be assessed in order to identify which costs qualify for capitalization or deferral. It permits recognition of these costs as an asset if they meet the GAAP criteria for capitalization. Other organizational costs are not specifically addressed in GAAP literature resulting in varied practices. Companies which have capitalized these costs do so under the matching concept of relating costs to revenue. Under this theory, revenue will be realized through future operations and therefore the costs should be deferred and expensed in the future when the revenue is recognized. Because the future benefit is rarely certain or measurable and the future period over which deferred costs might be allocated is usually arbitrary, deferral is not consistent with the Conservatism and Recognition concepts included in the Statement of Concepts.

7. FAS 86 reaffirms the provisions of FAS 2 for the treatment of software developed to be sold, leased or otherwise marketed by requiring the related software development costs to be expensed as incurred, with the exception of software costs incurred subsequent to the research and development phase but prior to making the software available to the public. Paragraphs 5, 6 and 8 through 11 of FAS 86 allow these costs to be capitalized. For the purposes of this paper, these costs are not considered to be different from the other costs incurred during a preoperating or research and development period and are included in the conclusion to expense these costs as incurred.

Drafting Notes/Comments

- Accounting treatment of goodwill, real estate, EDP equipment and software and furniture and equipment are addressed in separate issue papers.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. The majority of states do not specifically address the admission of preoperating costs in their insurance regulations and statutes. Typically, a reference is made to the treatment of goodwill and all other intangible assets. An example of this type of state guidance is New York Statutes - Insurance Laws, Chapter 28 of the Consolidated Insurance Laws, Article 13, *Assets and Deposits*, which states:

> The following shall not be allowed as admitted assets of a domestic or foreign insurer or the United States branch of an alien insurer in any determination of its financial condition:
>
> (1) Goodwill, trade names, agency plants and other like intangible assets.

9. Several states do make specific reference to organization costs in their insurance regulations and statutes. For example, Maryland Insurance Statutes - Insurance Laws, Article 48A -- Insurance Code, Subtitle 5, *Assets and Liabilities*, explicitly requires the nonadmission of organization costs, as opposed to expensing them as incurred.

Generally Accepted Accounting Principles

10. FAS 2, paragraph 12, states that "*All research and development costs encompassed by this Statement shall be charged to expense when incurred.*"

11. FAS 2 contains the following definitions:

> 8. For purposes of this Statement, research and development is defined as follows:
>
> a) Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process.
>
> b) Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.

12. FIN 6, paragraph 5, states:

> When software for use in research and development activities is purchased or leased, its cost shall be accounted for as specified by paragraphs 11(c) and 12 of *Statement No. 2.* That is, the cost shall be charged to expense as incurred unless the software has alternative future uses (in research and development or otherwise).

13. FAS 86 amends FAS 2 and FIN 6 to provide guidance on accounting for software developed internally for sale, lease or other marketing. FAS 86, paragraph 3, states:

> All costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are research and development costs. These costs shall be charged to expense when incurred as required by FASB Statement No. 2, *Accounting for Research and Development Costs.*

14. FAS 86, paragraphs 5 and 6, addresses the treatment of the costs of internally developed software that has completed the research and development phase but has not been made available to the public. FAS 86, paragraph 5, states:

> Costs of producing product masters incurred subsequent to establishing technological feasibility shall be capitalized. Those costs include coding and testing performed subsequent to establishing technological feasibility. Software production costs for computer software that is to be used as an integral part of a product or process shall not be capitalized until both (a) technological feasibility of the product has been established for the software and (b) all research and development activities for the other components of the product or process have been completed.

15. FAS 86, paragraph 6, states:

> Capitalization of computer software costs shall cease when the product is available for general release to customers. Costs of maintenance and customer support shall be charged to expense when related revenue is recognized or when those costs are incurred, whichever occurs first.

16. Paragraphs 8 through 11 of FAS 86 address the accounting and disclosure requirements for software costs capitalized under the provisions of paragraph 5 above.

