



URGENT ISSUE PAPER

RECOMMENDATION AND RISKS/BENEFITS FOR: ALLOWABILITY OF FINANCING COSTS (INCLUDING INTEREST) FOR CAPITALIZED COMPUTER SOFTWARE DEVELOPMENT PROJECTS

**AGA'S PARTNERSHIP FOR INTERGOVERNMENTAL MANAGEMENT
AND ACCOUNTABILITY**

OMB CIRCULAR A-87 WORKGROUP

INFORMATION TECHNOLOGY AND SHARED SERVICES SUB-WORK GROUP

ISSUE

2 CFR Part 225, Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87), Appendix B, Section 23 currently disallows interest with the exceptions of interest incurred to acquire or construct three types of assets: land, buildings or equipment. Software development projects are intangible assets and thus are not specifically addressed by the three "allowable" types of assets. Federal agencies have interpreted 2 CFR Part 225 guidance as disallowing financing costs (including interest) for software development. States claim that the disallowance hampers modernization improvements.

RECOMMENDATION

The workgroup recommends that OMB issue an interpretation of 2 CFR Part 225 to clarify whether financing costs for software development projects are allowable or unallowable, and if allowable, that OMB specify the criteria necessary to establish cost allowance.

The state government participants of the workgroup recommend that OMB issue an interpretation to allow software financing costs (including interest) for state and local government grantees. The work group participant representing the Division of Cost Allocation in the Federal government is neutral on whether OMB should allow or disallow these costs.

RISKS OF ALLOWING FINANCING COSTS FOR SOFTWARE PROJECTS

1. Financing costs for software development projects may be significant. Allowing state and local government grantees to charge these types of costs to Federal programs will result in increased costs to Federal programs. For example, one large state is currently considering debt

- financing up to \$1.36 billion for a large Enterprise Resource Planning (ERP) system. Once the system is completed and implemented, the state estimates that 18% of the project costs would be allocated to Federal programs over a period of several years.
2. State software projects may be large and complex, requiring the cooperation of multiple state agencies and outside vendors. There have been instances of large state software projects failing or experiencing significant delays. Therefore, if interest is allowed, it should only be allowed subsequent to successful software project implementation.
 3. 2 CFR Part 225, Appendix B, Section 23 currently disallows interest with the exception of interest incurred to acquire or construct land, buildings or equipment. Software development projects are intangible assets. Allowing financing costs for these types of projects would further broaden the exceptions to disallowance of interest costs.

BENEFITS OF ALLOWING FINANCING COSTS FOR SOFTWARE PROJECTS

1. The GASB issued Statement No. 51 in June 2007, requiring capitalization and amortization of software development projects as capital assets. Since the financial accounting requirements for software development projects is becoming similar to the accounting requirements for tangible assets (buildings and equipment), it may be equitable to broaden the interest allowability exceptions to encompass capitalized software development projects that are capitalized and amortized in accordance with GASB 51. GASB 51 is effective for financial statements for periods beginning after June 15, 2009.
2. Many state governments are currently experiencing large general fund budget deficits. There may be a growing need for state governments to issue debt to finance software development projects. 2 CFR Part 225, Appendix A, paragraph A.1. states that "The principles are designed to provide that Federal awards bear their fair share of cost recognized under these principles except where restricted or prohibited by law." In the current budgetary environment faced by the states, debt financing of software projects may be a necessary and reasonable expense that ultimately benefits Federal programs.
3. Successful software development projects may improve the efficiency of and accounting for Federal programs operated by the state and local governments. Disallowing interest costs for these projects may discourage these initiatives.
4. Question 3-4 of DHHS Implementation Guide for OMB Circular A-87 (ASMB C-10) asks "Where financing was obtained to develop an ADP system, are there any limitations with respect to claiming interest expense associated with these costs?" "Answer: Interest is only allowable on capital expenditures where there is interest expense and depreciation (or use allowance) in the current period. If development costs are not amortized, i.e. written off as expenditures, then no interest is allocable or allowable under Federal programs. However, interest expense incurred in

the first year of the expenditure is allowable.” For software projects capitalized and amortized in accordance with GASB 51, allowing the associated interest costs may be consistent with the DHHS Implementation Guide. In addition, the answer to Question 3-3 of the Implementation Guide states “At the time of this guide’s publication, no applicable industry-wide government accounting standards exist for the treatment of these costs. Governmental units are to treat these costs in accordance with their established capitalization policies. In the future, should the Governmental Accounting Standards Board issue applicable pronouncements on this subject, governmental units will be required to follow them.” As previously mentioned, GASB 51 has been issued.

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The Partnership for Intergovernmental Management and Accountability (Partnership) was established by the Association of Government Accountants (AGA) in September 2007 to open the lines of communication among governments. The mission of the A-87 Work Group is to identify and prioritize issues or concerns relating to 2 CFR Part 225, *Cost Principles for State, Local and Indian Tribal Governments*, and provide recommendations for alternative approaches that could benefit all levels of government. AGA is the premier Association in advancing government accountability. AGA supports the careers and professional development of government financial professionals working in federal, state and local governments, as well as the private sector and academia. Founded in 1950, AGA has a long history as a thought leader for the government accountability profession. Through education, research, publications, certification and conferences, AGA promotes transparency and accountability in government. www.agacgfm.org