APPENDIX 4-A: COMPUTER SOFTWARE CAPITALIZATION POLICY

ACCOUNTING POLICIES

SUBJECT: Computer Software Capitalization Policy	2002/03/12 V 00	SECTION A1000

1.1 Purpose

To establish the accounting policies and recommended accounting treatment to account for computer software. To ensure expenditures are appropriately capitalized on the balance sheet (capital) or expensed to operations in the period incurred (expense).

1.2 Scope

The accounting policy should be applied to all companies within the Toronto Hydro Group, as applicable.

(Specify the subjects within the scope or the range of the accounting policy, if applicable. Not applicable.)

1.3 Definitions

1.3.1 Software are computer programs, written in machine-readable language, that control the operations hardware or that enable users to

perform certain tasks on the computer. The two principle categories of software are systems and applications programs.

1.3.2 Systems software, which controls the computer system, or hardware, includes the operating system. The operating system manages a computer's internal functions: controls input, output and storage and, in general, handles its interactions with applications programs. Applications software enables users to accomplish particular tasks.

1.4 References

1.4.1 CICA Handbook ("CICA HB") Section 3060 – Capital Assets

1.4.2 CICA HB Section 3450 – Research and Development Costs

1.4.3 OEB Accounting Procedures Handbook for Electric Distribution Utilities ("APHandbook")

1.5 Accounting Policy

1.5.1 Governing Principle

Expenditures are capitalized to provide an equitable allocation of cost among existing and future customers. As assets are expected to provide future benefits, expenditures incurred for the acquisition, construction or development of assets should be capitalized and allocated over the estimated useful lives of the associated assets in the form of amortization.

Accordingly, expenditures related to the acquisition or betterment of an asset, where future benefits are reasonably assured, should be capitalized as an asset and all other expenditures should be expensed in the accounting period incurred.

1.5.2 General concepts

i. Computer software, developed or obtained for internal use, where future benefits are reasonably assured, is an intangible capital asset. (CICA HB)

ii. Capital assets are expenditures for which the future benefits to the company extend over one or more accounting periods / years.

iii. Expenses, frequently referred to as operating expenses, are expenditures where the benefits do not extend beyond the current accounting period / year.

iv. Future benefit involves a capacity of the asset to contribute directly or indirectly to future net cash flows.

1.5.3 System software

System software should be capitalized since it is an integral component to the operation of the hardware.

1.5.4 Application software

Application software related to specific software systems should be

capitalized, e.g. Customer Information System, Ellipse, LDC Settlement, EARMS, GEAR, etc.

1.5.5 PC Desktop Software

Personal computer desktop software, both system and application software, should be expensed in the accounting period incurred due to its relatively immaterial nature as well as for practical purposes. Some examples would include Microsoft Project 98, Microsoft Windows, Microsoft Office, etc. The rationale for this decision is based upon weighing the costs of administering the asset class and the benefits that the enhanced cost tracking provides from an internal control perspective.

1.5.6 Betterments (capital) versus expense (operating)

Expenditures that meet the definition of a betterment should be capitalized.

i. Betterments costs are those incurred to "enhance" the service potential of "existing" computer software. Service potential may be enhanced when there is an increase in the previous assessed physical output or service capacity, associated operating costs are lowered, the life or useful life is extended, or the quality of output is improved.

ii. Expenses are defined as the costs incurred in the "maintenance" of the service potential of a capital asset. Expenses are costs incurred more or less on a continuous basis to keep the software at its normal operation level, but do not add materially to the use value of the software, nor prolong its life appreciably, e.g. software maintenance contracts.

1.5.7 Software costs to be capitalized

Cost

Cost is the amount of consideration given up to acquire, construct, develop, or better a capital asset. It includes all cost directly attributable to the acquisition, construction, development, or betterment of the capital asset including installing it at the location and in the condition necessary for its intended use.

In-house software development

Capitalization of in-house software development costs should occur once the technical feasibility of the software has been established.

The costs to be capitalized are:

i. Program development costs

ii. Coding
iii. Testing
iv. Production of training and system documentation
v. Training costs for the implementation team, incurred during the software implementation period. For this purpose, the implementation period would be complete when the software is put in service.

The costs to be expensed are planning, conceptual design, establishing feasibility, and user training and other on-going support costs.

Definition of technical feasibility: Where the feasibility of an in-house software development has been established; and management approval to proceed has been obtained; and an RFP has been issued, if purchased software.

Purchased software

The costs to be capitalized are:

i. Direct costs associated with the purchase price of the software, e.g. training costs for the implementation team, incurred during the software implementation period. Costs of associated equipment would be capitalized as a tangible capital asset within computer hardware.

ii. Costs of user customization, installation and testing to make the software operational.

Other costs to be expensed during the life of the software

i. Software system maintenance
ii. User training and other on-going support costs
iii. Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity (modifications), after the system is in the production environment.

1.6 Amortization

Consistent with the CICA HB, the OEB APHandbook does not provide prescriptive guidance in terms of the amortization methods to be used, the asset categories, and the estimated useful lives or amortization rates. Instead, it is expected that in the absence of an objective study to support changes to the current methods, lives or rates, utilities will continue to use methods, lives or rates consistent with past practice. Note that the OEB may review the selected amortization methods, estimated useful lives and amortization rates, as it considers necessary.

i. Amortization of software costs is usually done over a three to five

year period. Five years in some cases is considered the upper limit because this is generally the same asset life for the associated hardware. The decision on the period to choose is dependent upon management's assessment of the useful service life, a matter of professional judgement in each case. The useful life of the Banner CIS system was determined to be seven years.

ii. The company should recognize amortization in a rational and systematic manner appropriate to the nature of the software and its intended use, to match costs to the related benefits.

iii. The amortization method and estimates of the life of a capital asset should be reviewed on a regular basis.

1.7 Materiality and minimum threshold dollar amounts for capitalization

For practical purposes, once an expenditure has been determined as capital in nature, only those expenditures which exceed the threshold dollar amount of $2,000 should be treated as capital. Expenditures below this threshold amount should be treated as an immaterial expense in the period incurred.

1.8 OEB Uniform System of Accounts

The APHandbook defines computer software account #1925 as follows:

This account shall include the cost of developed and purchased computer operating and application software that is material in amount.

Example items:

i. Accounting packages
ii. Customer Information System
iii. Groupware packages, e.g. e-mail, scheduling and conferencing programs, etc., including gateways
iv. Database management system packages
v. Software development tools
vi. Primary development tools, e.g. PowerBuilder

1.9 Capital assets definition (CICA HB)

Computer software is a capital asset. Capital assets are defined as identifiable assets comprising property, plant and equipment and intangible properties that meet the following criteria:

i. Are held for use in the production or supply of goods and services, for rental to others, for administrative purposes, or for the development, construction, maintenance or repair of other capital assets;
ii. Have been acquired, constructed or developed with the

intention of being used on a continuing basis; and

iii. Are not intended for sale in the ordinary course of business.