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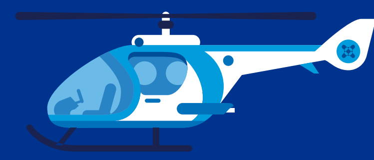

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EITF reaches tentative conclusion on implementation costs for cloud computing

October 13, 2017

KPMG reports on the EITF decision, which would reverse the recent ASU on customers' accounting for cloud computing.[1]

Applicability

All companies that are customers in 'hosting arrangements' that under current US GAAP do not transfer a software license to the customer (i.e. cloud computing arrangements, or CCAs).[2]

Key facts and impacts

The FASB's Emerging Issues Task Force (EITF) reached a tentative conclusion at its October 12, 2017 meeting that CCAs and software licensing arrangements[3] are economically similar and should be accounted for consistently.

The tentative conclusion would become an official EITF consensus after it is exposed for public comment if it is ratified by the FASB. A consensus would effectively reverse the recently issued ASU on customer's accounting for cloud computing fees[4] by including CCAs in the scope of the internal-use software guidance.[5] Therefore, customers would capitalize a right-to-use software asset and a related liability to pay for that asset over time (unless the CCA is prepaid). The capitalized cost of the CCA right-to-use asset would include those implementation costs that currently qualify for capitalization in a software licensing arrangement.

It is expected that a consensus would reduce diversity in practice by customers that incur costs to implement solutions governed by CCAs (i.e. cloud solutions).

The tentative conclusion would not affect the accounting for cloud service providers, or other software vendors.

KPMG observation

If the EITF's tentative conclusion is finalized as a consensus, it would result in companies capitalizing potentially significant implementation costs that are often expensed as incurred under current US GAAP, and recognizing them as expenses over an extended period of time. A consensus would also result in recognizing new assets and liabilities for the right to use the hosted software that is subject

[1] EITF Issue No. 17-A, Customer's Accounting for Implementation, Setup, and Other Upfront Costs (Implementation Costs) Incurred in a Cloud Computing Arrangement That Is Considered a Service Contract

[2] 'Hosting arrangement' is a defined term in the ASC Master Glossary; ASC 350-40-15-4A – 14-4C

[3] Including hosting arrangements that meet the criteria in ASC 350-40-14-4A

[4] ASU 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

[5] ASC 350-40, Intangibles—Goodwill and Other—Internal-Use Software

KPMG observation

to the CCA and the related obligation to pay for that right-to-use asset over time, which would affect companies' financial ratios, debt covenants and deferred tax accounting.

There may be additional effects from future decisions on this Issue reached by the EITF, which are discussed in the 'Next steps' section.

Current guidance

US GAAP currently distinguishes between arrangements that transfer a software license to a customer,[6] and CCAs, which provide the customer with the right to access software but do not, for accounting purposes, transfer a license to the customer.

Accounting for software licensing arrangements

A customer that acquires a software license (including in a hosting arrangement that meets the criteria in ASC 350-40-15-4A) recognizes an intangible asset – i.e. the software license – and a corresponding liability to pay for it over time (unless the license is prepaid).[7] Most costs to implement the licensed software (e.g. costs to customize, configure and/or install the software in the customer's IT environment) are capitalized. Certain other costs typically incurred before a customer 'goes live' with a new software solution, such as data conversion[8] or training, are expensed as incurred.[9]

Software licensing arrangements frequently include multiple elements. For example, the fees paid by the customer for the software license may also entitle the customer to the right to receive future unspecified software updates, upgrades and enhancements and telephone support (collectively, post-contract customer support or PCS).

In a hosting arrangement that includes a software license, the customer also receives a hosting service. The contractual fee may be an aggregate fee or may be separately stated for each element of the arrangement. Regardless of stated prices in the contract, the customer generally needs to determine the relative fair value of each element because it is accounted for differently.

For example, the relative fair value of the software license is capitalized up-front and amortized over the useful life of the software license, the relative fair value of data conversion or training services is expensed as incurred, and any prepaid PCS or hosting service fees will be expensed over the period of service that is covered by the prepayment (e.g. the first year of the arrangement).

Accounting for cloud computing arrangements

Under US GAAP, the CCA is accounted for as a service arrangement; no software license is conveyed to the customer.[10] The only amounts recognized on the balance sheet by the customer are those that result from the general application of accrual accounting. For example, a customer capitalizes a prepaid asset for fees paid to the cloud service provider in advance, and may recognize a liability for usage-based fees it incurs if it has not yet paid those fees at the financial reporting date.

Generally, most implementation costs are expensed as the related implementation activities are performed; they are not recognized over a longer period such as the CCA term. This occurs regardless of whether the costs are incurred as a result of activities performed by internal personnel, the cloud service provider or an unrelated third party (e.g. a consultant). Some of those costs may be expensed as incurred because they are business process re-engineering costs.[11]

[6] Includes hosting arrangements that meet the criteria in ASC 350-40-15-4A

[7] ASC 350-40-25-17

[8] Other than those incurred to acquire data conversion software, see ASC 350-40-25-3

[9] ASC 350-40-25-4 – 25-5

[10] ASC 350-40-15-4C

[11] ASC 720-45, Other Expenses—Business and Technology Reengineering

However, certain costs related to implementation activities may be within the scope of other US GAAP and capitalized. For example, IT equipment purchased by the company that will be used with the cloud solution is generally capitalized under guidance on property, plant and equipment.[12] While costs to develop (e.g. coding and testing) and implement interfaces in the company's IT environment – e.g. to permit its existing ERP or human resources system to interact with the cloud solution -- are capitalized under the internal-use software guidance.

In addition, some implementation costs not within the scope of other guidance that are *paid to the cloud service provider* may be capitalized as a prepayment for the cloud solution and amortized over the CCA term.

There is presently diversity in practice as to which implementation costs should receive that treatment. For example, some companies apply that treatment to any costs that enhance the functionality of the cloud solution, while others apply that treatment only if the cloud service provider is the only vendor capable of making those enhancements.

Capitalization of implementation costs under the EITF tentative conclusion

Costs incurred to implement the CCA (e.g. costs to configure the software to the customer's needs) would be accounted for in the same manner as costs to implement software in a software licensing arrangement. Implementation costs that are currently capitalized in software licensing arrangements would also be capitalized in CCAs, while those expensed in software license arrangements (e.g. data conversion and training costs) would be expensed in CCAs.

Generally this means that often significant costs to customize or configure the cloud solution to the customer's needs or interface the cloud solution with other customer resources not addressed by other guidance (e.g. that on business process re-engineering) would now be capitalized. This would occur regardless of who performs the implementation services – i.e. internal resources, the cloud service provider, or an unrelated third party.

The EITF tentative conclusion would treat the newly capitalizable implementation costs as an incremental cost of the acquired right-to-use software asset (see 'Accounting for the cloud solution fees').

Definition of implementation costs

The EITF decided that implementation costs did not need to be defined or explained in the revised guidance. Most EITF members expressed the view that ASC 350-40 already provided sufficient guidance, and companies and practitioners understand what costs and activities fall into this broad category.

KPMG observation

Allocation considerations

Companies may engage a single provider, which may be the cloud service provider or a third party, to perform multiple implementation activities. Because not all implementation costs would be capitalizable under the EITF tentative conclusion – e.g. data conversion, training and business process re-engineering costs would not be capitalizable – companies would need to allocate costs between capitalizable and non-capitalizable implementation activities on a relative fair value basis. A company's efforts should be consistent with its current practice for software licensing arrangements.

Capitalizable and non-capitalizable implementation costs

The EITF Issue Summary Supplement produced by the FASB staff included the following examples of implementation activities:[13]

— integration (developing interfaces between the hosted software and the entity's other systems);
— customization, either of the entity's other systems or of the hosted software;
— configuration, either of the entity's other systems or of the hosted software;
— data conversion or migration;
— installation;

[12] ASC 360, Property, Plant and Equipment

[13] Issue Summary No. 1, Supplement No. 1, September 28, 2017

KPMG observation

— architecture and design;
— coding;
— testing;
— training; and
— business process re-engineering.

Because the EITF tentative conclusion is to account for software licensing arrangements and CCAs in the same way (i.e. consistent with the current guidance that applies to software licensing arrangements), not all implementation costs would be capitalizable. For example, costs incurred for data conversion and migration, training and business process re-engineering activities would not be capitalizable even though they typically occur during the implementation process (or phase) for a CCA.

Accounting for the cloud solution fees

In addition to changing the accounting for CCA implementation costs, the tentative conclusion would reverse the guidance in ASC 350-40 that ASU 2015-05 created. Instead of accounting for the fees paid (or to be paid) to the cloud service provider for access to the hosted software as payments for a service (e.g. software-as-a-service), the customer would account for the CCA as the acquisition of a 'right-to-use' software asset and an obligation (liability) to pay for that asset over time (if the fees are not prepaid). This is the same as the current accounting for software licensing arrangements (see 'Current guidance' section).

Recognition and measurement

The EITF did not reach decisions about the initial or subsequent measurement of the right-to-use software asset and related liability. Rather, the EITF instructed the FASB staff to conduct further research on these issues (see 'Next steps' section).

Much of the EITF discussion centered on whether, and if so how much, the revised guidance should refer (or analogize) to the new leases guidance.[14]

Allocating contract consideration

Companies already allocate contract consideration between license and non-license elements, and between capitalizable and non-capitalizable implementation costs in software licensing arrangements. Therefore, the EITF tentatively concluded that no additional guidance was needed to allocate consideration for CCAs – i.e. allocate consideration between the right-to-use software asset and the hosting element, and between capitalizable and non-capitalizable implementation costs.

The EITF discussed, but did not vote on, a practical expedient that would give customers the option not to separate the right-to-use software element from the hosting service element in CCAs. This would be similar to the practical expedient in the new leases guidance that permits lessees not to separate lease and non-lease components.[15]

KPMG observation

We believe the decision on allocation guidance may be revisited before a consensus-for-exposure is issued. The FASB staff has been instructed to perform additional research before the next EITF meeting, and those results may influence whether the EITF needs to make additional decisions about allocating CCA consideration to different elements.

[14] ASC 842, Leases; and KPMG's Handbook: Leases

[15] ASC 842-10-15-37

Issues not discussed

The following issues were included in the EITF issue summary, but were not discussed:

— whether to limit the scope of the guidance to only some CCAs (e.g. those in which the cloud computing element is the 'predominant' element in the arrangement);
— disclosure requirements;
— transition method(s); and
— effective date.

Those issues will be discussed at a future EITF meeting.

Next steps

The EITF asked the FASB staff to research several issues including:

— whether there is diversity in the application of ASC 350-40 to software licensing arrangements – e.g. in determining the useful life of capitalized software assets, in measuring the liability for software licenses paid over time, and in allocating consideration between multiple elements;
— how to determine the useful life of the new CCA right-to-use software asset;
— how to determine the discount rate for the CCA liability that would be recognized when the CCA is paid for over time;
— how to present the income statement amortization of the right-to-use software asset and interest/accretion of the discounted CCA payment liability – i.e. as a single straight-line operating cost (similar to operating leases under ASC 842), or as separate interest and amortization expense (similar to software licensing arrangements under current US GAAP and finance leases under ASC 842); and
— how the new leases guidance might be applied to, or repurposed for, CCAs – e.g. with respect to accounting for renewal options and balance sheet and income statement presentation.

The timing of the next EITF meeting will depend on when the FASB staff can complete its research and outreach.

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