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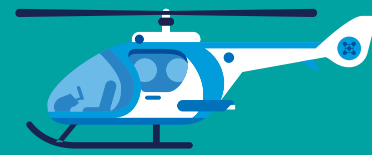

EITF consensus-for-exposure on accounting for implementation costs of cloud computing arrangements

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KPMG reports on the EITF consensus-for-exposure that would defer certain cloud computing implementation costs that were previously expensed as incurred.[1]

Applicability

All companies that are customers in either:

- software licensing arrangements (this includes 'hosting arrangements' that transfer a software license to the customer);[2] or
- cloud computing arrangements (i.e. all hosting arrangements that do not transfer a software license to the customer).[3]

Key facts and impacts

On January 18 the FASB's Emerging Issues Task Force (EITF) reached a consensus-for-exposure, which is subject to ratification by the FASB, that implementation costs incurred by customers in cloud computing arrangements (CCAs) should be deferred if those same costs would be capitalized by the customer in a software licensing arrangement under the internal-use software guidance.

If, as expected, the FASB ratifies the EITF's consensus-for-exposure, a proposed Accounting Standards Update (ASU) will be issued for comment.

The consensus-for-exposure would not affect the accounting by cloud service providers or other software vendors, nor would it change the accounting by customers for software licensing arrangements. However, it would impose some new disclosure requirements on those customers.

KPMG observation

The EITF's consensus-for-exposure would require companies to defer potentially significant, specified implementation costs that are often expensed as incurred under current GAAP, and recognize them as expenses over the term of the CCA (plus optional renewal periods that are reasonably certain to be exercised by the customer). In addition to changing the timing of income statement recognition of these CCA implementation costs, the new deferred implementation cost assets would affect companies' financial ratios and deferred tax accounting.

[1] The EITF consensus-for-exposure revises the EITF's prior tentative conclusions reached in October 2017, which were described in KPMG's Defining Issues, EITF reaches tentative conclusion on implementation costs for cloud computing

[2] Hosting arrangements that meet the criteria in ASC 350-40-15-4A

[3] ASC Master Glossary, 350-40-15-4A – 14-4C

Current guidance

US GAAP distinguishes between arrangements that transfer a software license to a customer[4], 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 transfers a software license to the customer) recognizes an intangible asset – i.e. the software license – and a corresponding liability to pay for it over time (unless the license is prepaid).[5] 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[6], training and business process reengineering are expensed as incurred.[7]

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 receive future unspecified software updates, upgrades and enhancements and telephone support (collectively, post-contract customer support (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 must determine the relative fair value of each element that 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, a CCA is accounted for as a service arrangement because no software license is conveyed to the customer.[8] 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 recognizes a prepaid asset for fees paid in advance to the cloud service provider, 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 reengineering costs.

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.[9]

Costs to develop (e.g. coding and testing) and implement interfaces in the company's IT environment are capitalized under internal-use software guidance. Those costs may be incurred, for example, to permit the company's existing ERP or human resources system to interact with the cloud solution.

Some implementation costs not within the scope of other guidance that are paid to the cloud service provider may be deferred as a prepayment for the cloud solution and recognized over the CCA term. There is diversity in practice about which implementation costs should receive that treatment. Some companies apply that

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

[5] ASC 350-40-25-17

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

[7] ASC 350-40-25-4 – 25-5; ASC 720-45, Other Expenses—Business and Technology Reengineering

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

[9] ASC 360, Property, Plant, and Equipment

treatment to any costs paid to the cloud service provider 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. The EITF believes the consensus-for-exposure would reduce that diversity in practice.

Deferral of implementation costs under the EITF consensus-for-exposure

Costs incurred to implement a CCA (e.g. costs to configure the software to the customer's needs) would be (1) deferred or (2) expensed as incurred in accordance with the guidance for the capitalization or expensing of such costs under existing internal-use software guidance.

Implementation costs that are currently capitalized in software licensing arrangements would be deferred in CCAs, while those expensed as incurred in software license arrangements (e.g. data conversion and training costs) would also 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, such as business process reengineering guidance, would be deferred. This would occur regardless of who performs the implementation services – i.e. internal resources, the cloud service provider or an unrelated third party.

Definition of implementation costs

The EITF decided that implementation costs did not need to be defined or illustrated 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 deferred under the EITF consensus-for-exposure – e.g. data conversion, training and business process reengineering costs would not be deferred – companies would need to allocate costs between deferrable and non-deferrable implementation activities on a relative fair value basis (consistent with what is required for software licensing arrangements).

Capitalizable and non-capitalizable implementation costs

The EITF Issue Summary Supplement issued for the October 2017 EITF meeting included the following examples of implementation activities:[10]

- integration (developing interfaces between the hosted software and the company's other systems);
- customization, either of the company's other systems or of the hosted software;
- configuration, either of the company's other systems or of the hosted software, data conversion or migration;
- installation;
- architecture and design;
- coding;
- testing;
- training; and
- business process reengineering.

Recognition period

The EITF consensus-for-exposure would provide guidance about the period over which to recognize the deferred implementation costs. It would require companies to recognize the implementation costs to expense over a period comprising the contractual term of the CCA plus any optional renewal periods that are reasonably certain to be exercised by the customer. The FASB staff observed that 'reasonably certain' is a high threshold of likelihood, and the application of that term should be consistent with how it is applied under the new leases guidance.[11]

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

[11] ASC 842, Leases

The staff also observed that the rapid obsolescence of technology will affect the evaluation of whether that threshold is met.

Income statement presentation of deferred implementation costs

The expense for deferred implementation costs, when recognized, would be presented in the income statement in the same manner as the CCA fees paid to the cloud service provider.

Disclosure requirements

The EITF decided to seek feedback in the proposed ASU on a package of quantitative and qualitative disclosure requirements that would apply to implementation costs for CCAs and software licensing arrangements.

Those disclosures include:

- a general description of the terms and conditions of the company's CCAs and software licensing arrangements for which implementation costs have been deferred and capitalized, respectively;
- the significant judgments and assumptions that the company made in applying the proposed requirements;
- qualitative and quantitative information about implementation costs that were expensed and those that were deferred (CCAs) or capitalized (software licensing arrangements); and
- information about the period over which deferred (CCAs) or capitalized (software licensing arrangements) implementation costs are recognized as an expense.

Transition

The EITF decided to permit a company to choose between prospective and retrospective transition. Under prospective transition this consensus-for-exposure would apply only to CCAs that are entered into, renewed or materially modified on or after the effective date of a final ASU.

Retrospective transition would require application of the guidance in the consensus-for-exposure to all periods presented in the financial statements.

KPMG observation

The EITF decided that the CCA is the unit of account for deferral of implementation costs. Therefore, companies that want to defer implementation costs that have not yet been incurred, but for which implementation activities have commenced before the effective date of the guidance, would be required to adopt the guidance retrospectively.

Transition disclosures

The EITF consensus-for-exposure would require a company to disclose the nature of, and reason for, the change in accounting principle, the transition method selected, and a qualitative description of the financial statement line items affected by the accounting change. In addition to those transition disclosures, companies that adopt these proposed accounting changes retrospectively would be required to provide quantitative information about the effects of the accounting change.

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