



Defining Issues[®]

FASB issues ASU on accounting for implementation costs of cloud computing arrangements

August 30, 2018

KPMG reports that certain cloud computing implementation costs previously required to be expensed as incurred will be deferred and recognized over the arrangement's term.

Applicability

Companies that are customers in cloud computing arrangements (i.e. 'hosting arrangements' that do not transfer a software license to the customer¹).

A hosting arrangement, which is defined in the ASC Master Glossary, is an arrangement that allows customers to access and use software on an as-needed basis without having possession of it.

Key facts and impacts

On August 29, the FASB issued an ASU² based on a consensus of the FASB's Emerging Issues Task Force (EITF) that requires implementation costs incurred by customers in cloud computing arrangements (CCAs) to be deferred and recognized over the term of the arrangement, if those costs would be capitalized by the customer in a software licensing arrangement³ under the internal-use software guidance in ASC 350-40.

KPMG observation

The ASU requires companies to defer potentially significant, specified implementation costs incurred in a CCA that are often expensed as incurred under current US GAAP, and recognize them to expense over the noncancellable term of the CCA (plus optional renewal periods that are either reasonably certain to be exercised by

the customer or controlled by the cloud service provider). In addition to changing the timing of income statement recognition of these implementation costs, the new deferred implementation cost assets will affect companies' financial ratios and deferred tax accounting.

¹ Hosting arrangements that do not meet the criteria in ASC 350-40-15-4A. For additional information about applying these criteria, see Chapter A: Scope of KPMG's Handbook, [Revenue for Software and SaaS](#).

² ASU 2018-15, [Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract](#)

³ Includes hosting arrangements that transfer a software license to the customer based on the criteria in ASC 350-40-15-4A

Current guidance

US GAAP distinguishes between software licensing arrangements and CCAs.

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).⁴

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,⁵ training and business process reengineering are expensed as incurred.⁶

Software licensing arrangements frequently include multiple elements. For example, in addition to the software license, they might include:

- rights to future unspecified software updates, upgrades and enhancements;
- telephone support;
- professional services; and
- hosting services (i.e. in hosting arrangements that include a software license).

In multiple element arrangements, the customer generally must determine the relative fair value⁷ 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 support or hosting service fees are 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

A CCA is accounted for as a service arrangement because no software license is conveyed to the customer.⁸ The only amounts the customer recognizes on the balance sheet are those that result from the application of accrual accounting (e.g. a prepaid asset for subscription fees paid in advance to the cloud service provider, or a liability for usage-based fees incurred but not paid 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 for activities performed by internal resources, 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 the 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. However, diversity exists.

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 sole vendor capable of making those enhancements. The EITF expected the ASU to reduce that diversity.

⁴ ASC 350-40-25-17

⁵ Other than those costs incurred to acquire data conversion software; see ASC 350-40-25-3.

⁶ ASC 350-40-25-4 – 25-5; ASC 720-45, Other Expenses—Business and Technology Reengineering

⁷ ASU 2018-15 amends this guidance to now refer to 'standalone price', rather than fair value; see ASC 350-40-30-4.

⁸ ASC 350-40-15-4C

⁹ ASC 360, Property, Plant and Equipment

Guidance unchanged

The ASU does not affect the accounting by cloud service providers, other software vendors or customers' accounting for software licensing arrangements.

Deferral of implementation costs

Under the ASU, costs incurred to implement a CCA (e.g. configuring the software to the customer's needs) will be deferred or expensed as incurred using the internal-use software guidance.

Implementation costs that are currently capitalized in software licensing arrangements will be deferred in CCAs, while those expensed as incurred in software licensing arrangements

(e.g. data conversion¹⁰ and training costs) will also be expensed as incurred in CCAs.

This means that significant implementation costs (e.g. configuration costs) that are not addressed by other guidance will frequently be deferred. The costs will be deferred regardless of who performs the implementation services – i.e. internal resources, the cloud service provider or an unrelated third party.

Implementation costs not defined

Implementation costs are not defined or illustrated in the ASU. The EITF decided the concept of implementation costs was already well understood.

KPMG observation

Allocation considerations

Companies may engage a single cloud service provider or a third party to perform multiple implementation activities. Because not all implementation costs will be deferred under the ASU (e.g. data conversion¹⁰, training and business process reengineering costs) companies will need to allocate costs between deferrable and non-deferrable implementation activities on a relative stand-alone price basis (consistent with the requirements for software licensing arrangements).

Stand-alone price is the price at which a customer would purchase a contract element (e.g. a contracted good or service) separately.¹¹

Example implementation costs

During deliberations of the ASU, the EITF and the FASB staff discussed these examples:¹²

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

The last three activities in the list are not capitalizable under the internal-use software guidance or other US GAAP.

Recognition period

The ASU will require companies to recognize deferred implementation costs to expense over the 'term of the hosting arrangement'. Under the ASU, the term of the hosting arrangement comprises the noncancellable period of the CCA plus any optional renewal periods¹³ that are reasonably certain to be exercised by the

customer or for which exercise of the option is controlled by the vendor.

The FASB staff observed during EITF deliberations 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.¹⁴

¹⁰ See footnote 5 on page 2.

¹¹ ASC Master Glossary

¹² Issue Summary No. 1, Supplement No. 1, September 28, 2017

¹³ Includes periods covered by an option to terminate the lease.

¹⁴ ASC 842, Leases

KPMG observation

Assessment of reasonably certain

The ASU states that the company should consider all of these factors when determining the 'term of the hosting arrangement':

- obsolescence;
- technology;
- competition;
- other economic factors;
- rapid changes that may be occurring in the development of hosting arrangements or hosted software; and
- significant implementation costs that are expected to have significant economic value for the customer when the option to extend (or not to terminate) the hosting arrangement becomes exercisable.

We believe consideration of those factors, particularly consideration of significant implementation costs incurred and other economic factors such as switching costs, will frequently lead to a conclusion that the term of the hosting arrangement exceeds the noncancellable period of the CCA.

Absence of renewal options

The EITF concluded that the recognition period for the deferred costs should be aligned to the term of the hosting arrangement because the future economic benefit that will be derived from those deferred costs is inextricably linked to the customer having the continued right to access the hosted software.

CCAs may not include renewal options, even though the customer and the cloud service provider expect to agree on one or more renewals (e.g. through contract amendment).

Consequently, the recognition period for deferred implementation costs in these arrangements will be limited to the noncancellable term of the CCA.

The term may be shorter than the period over which the customer reasonably expects to benefit from the costs incurred or expected term of the hosting arrangement if the CCA had included renewal options.

The ASU may cause CCAs to include customer renewal options more frequently.

Reassessment of the recognition period

A company is required to periodically reassess the estimated term of the hosting arrangement over which deferred implementation costs are recognized. When doing so, the company considers the same factors as it considered initially (see KPMG observation, *Assessment of reasonably certain*).

A change in the recognition period is accounted for prospectively as a change in accounting estimate. The ASU does not provide guidance on:

- how often a company should 'periodically reassess' the recognition period; or
- what events or changes in circumstances should trigger a reassessment.

KPMG observation

The periodic reassessment requirement is generally consistent with the existing guidance on reassessing the useful life of internal-use software.¹⁵ Therefore, it would appear the EITF's intention was to apply it similarly. However, we do not believe, in general, that guidance is consistently applied.

Therefore, given the link the EITF makes in the new ASU to both the contract costs guidance¹⁶ and the new leases guidance, it may also be appropriate to consider the reassessment

requirements in those pieces of guidance in deciding when (or whether) to undertake a reassessment of the recognition period for deferred CCA implementation costs.

For example, the contract costs guidance requires updating the amortization period for contract cost assets when there is a significant change in the company's expected timing of transfer to the customer of the related good or service. And the new leases guidance provides a number of reassessment triggers that could similarly apply to a CCA.

¹⁵ ASC 350-40-35-5

¹⁶ ASC 340-40, Other Assets and Deferred Costs—Contracts with Customers

Impairment of deferred implementation costs

Deferred implementation costs will be assessed for impairment in the same manner as internal-use software assets.

This means deferred implementation costs will be subject to the impairment and abandonment

guidance that applies to long-lived assets.¹⁷ The ASU provides some examples of events or changes in circumstances ('triggering events') that would indicate the company should assess deferred CCA implementation costs for impairment.¹⁸

Financial statement presentation	
Balance sheet	A company presents deferred implementation costs in the same line item on the balance sheet as it presents a prepayment of fees for the CCA.
Income statement	The expense for deferred implementation costs is presented in the income statement in the same line item as the CCA fees paid to the cloud service provider.
Cash flow statement	Cash payments for CCA implementation costs are classified in the statement of cash flows consistent with how the fees for the CCA are classified. This generally means that these payments will be classified as cash outflows from operating activities.

KPMG observation	
Consistency between CCA fees and implementation costs The decisions on financial statement presentation reflect the preference of most EITF members to ensure a consistent link between the deferred implementation costs and the fees for the CCA. The ASU will result in the recognition of the expense for both implementation costs and the CCA fees over time, with consistent presentation throughout the financial statements.	EBITDA Earnings before interest, taxes, depreciation and amortization (EBITDA) is a non-GAAP measure. Therefore, the ASU does not address whether amortization of the deferred implementation costs should be excluded in the calculation of EBITDA. However, the FASB staff expressed the view that the term 'amortization' related to the recognition of the deferred costs is not intended to suggest that it is appropriate to increase EBITDA by excluding the periodic recognition of deferred implementation costs.

Disclosure requirements

The ASU requires a customer to disclose the nature of its hosting arrangements that are service contracts and provide disclosures as if the

deferred implementation costs were a separate, major depreciable asset class.

¹⁷ ASC 360-10-35

¹⁸ ASC 350-40-35-11

Effective date and transition

	Effective date
Public companies – Annual and interim reporting periods for fiscal years beginning after	December 15, 2019
All other companies – Annual reporting periods for fiscal years beginning after	December 15, 2020
All other companies – Interim reporting periods for fiscal years beginning after	December 15, 2021
Early adoption allowed, including interim periods?	Yes.

Transition	
Prospective transition	All CCA implementation costs for activities performed on or after the effective date, including costs for (1) new CCAs entered into on or after the effective date and (2) existing CCAs entered into before the effective date; or
Retrospective transition	Apply the ASU as if it had always been US GAAP (including in comparative periods).

Transition disclosures

A company will disclose the nature of, and reason for, the change in accounting principle, its transition method and qualitatively describe the

financial statement line items affected by the accounting change.

In addition, retrospective adopters will also quantitatively describe the effects of the accounting change.

Contributing authors

Kimber Bascom; Scott Muir; Rob Werling

KPMG's Financial Reporting View

kpmg.com/us/frv

kpmg.com/socialmedia



The descriptive and summary statements in this newsletter are not intended to be a substitute for the potential requirements of the standard or any other potential or applicable requirements of the accounting literature or SEC regulations. Companies applying U.S. GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors. Defining Issues® is a registered trademark of KPMG LLP.

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.