Cloud computing arrangements
Customer accounting for implementation costs

At a glance
On August 29, 2018, the FASB issued new guidance on a customer’s accounting for fees paid in a cloud computing arrangement that is hosted by the vendor, i.e., a service contract. Under the new guidance, customers will apply the same criteria for capitalizing implementation costs as they would for an arrangement that has a software license.

The new guidance also prescribes the balance sheet, income statement, and cash flow classification of the capitalized implementation costs and related amortization expense, and requires additional quantitative and qualitative disclosures.

Background
Accounting Standards Update (ASU) 2015-05, Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement, helps entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (CCA) by providing guidance for determining when an arrangement includes a software license and when an arrangement is solely a hosted CCA service.

If the CCA includes a software license, the arrangement is within the scope of the internal-use software guidance. This guidance addresses which costs should be capitalized, including the cost to acquire the license and the related implementation costs. If the CCA does not include a software license, the arrangement is a service contract and the fees for the CCA are recorded as an operating expense. ASU 2015-05 does not specifically address the accounting for implementation costs related to a service contract.

The FASB’s new guidance¹ aligns the requirements for capitalizing implementation costs in a CCA service contract with the requirements for capitalizing implementation costs incurred for an internal-use software license.

Key provisions
The FASB broadened the definition of the term “hosting arrangement” in the master glossary to include hosted CCA services. Effectively, the definition now includes any arrangement in which the customer accesses or uses software but does not take possession of the software.

Entities that enter into hosted CCA service arrangements will apply the existing internal-use software guidance to determine which implementation costs are eligible for capitalization. Under that model, implementation costs are capitalized or expensed depending on the nature of the costs and the project stage during which they are incurred. For example, costs incurred during the application development stage of implementation would generally be capitalized, whereas costs incurred during the preliminary project and post implementation stages would generally be expensed as incurred.

PwC observation:
Although the internal-use software guidance focuses on the stage of the project in which the costs are incurred, implementation of a hosted CCA service is a process that may not occur linearly. That is, the same type of costs could be incurred at different stages of the implementation project. In these circumstances, entities should assess the nature of the costs incurred (e.g., implementation costs versus training costs or re-engineering costs), not solely the timing, to determine if the costs should be capitalized.

Determining which activities in the implementation process are eligible for capitalization requires judgment and an analysis of the nature of the costs incurred.

PwC observation:
We generally expect entities to separately assess the accounting for implementation costs for each significant module or component of the hosted CCA service. For example, when an entity implements multiple instances of the same hosted CCA service to different business units or geographies (which could be in different stages of implementation), the analysis of whether to capitalize the cost should be performed for each instance of the hosted CCA service.

The general guidelines included within the internal-use software guidance should be considered, and include the following:

- Activities to develop or obtain software that allow for access to or conversion of old data by new systems are capitalizable
- Activities related to coding and testing during the application development stage are capitalizable
- Training activities are not development activities and, if incurred during the development stage, are expensed as incurred
- Data conversion activities are expensed as incurred. The process of data conversion from an old system to a new one may include purging or cleansing existing data, reconciling the data in the old and new systems, creating new or additional data, and converting old data to the new system.
PwC observation:

The underlying software that comprises the hosted CCA service is considered internal-use software from the perspective of the vendor. As such, the customer’s analysis of the hosted CCA service should not be based on the stage of development of the underlying software. That is, just because the underlying vendor software is in the post-implementation stage from the vendor’s perspective, this does not mean the CCA service is in the post-implementation stage from the customer’s perspective.

Both internal and external costs (incurred by the CCA service provider or other third parties) are eligible for capitalization. Examples include:

- External direct costs of materials and services consumed including:
  - Fees paid to third parties/service provider for services provided to customize and/or configure the service
  - Travel expenses incurred by third parties or the service provider in their duties directly associated with implementing the hosted CCA service
- Internal payroll and payroll-related costs (e.g., costs of employee benefits or stock-based compensation) for employees who are directly associated with and who devote time to implementation during the development phase
- Activities to configure and/or customize the hosted CCA service, whether incurred by an internal or external party, would likely be part of the application development phase and eligible for capitalization.

PwC observation:

Management will need to assess its arrangements with CCA service providers to determine the fees that represent implementation costs. In some arrangements, the CCA service provider may not separate the fees for implementation services from the fees for the hosted CCA service; instead, there may be a single monthly payment stream for all services. In these cases, the entity will need to estimate the portion of the fee that relates to the implementation services in order to apply the new guidance to these costs.

Amortization

Implementation costs should be amortized over the term of the associated hosted CCA service on a straight-line basis, unless another systematic and rational basis is more representative of the pattern in which the entity expects to benefit from its right to access to the hosted software. The ASU specifies that the pattern of amortization should not be based on expectations about the entity’s usage of the hosted software (for example, how many transactions the entity processes or how many users access the hosted software).

The amortization period for capitalized implementation costs may extend beyond the initial noncancellable term of the hosted CCA. The amortization period should be based on the fixed noncancellable term of the hosted CCA plus all of following:

- Periods covered by an option to extend if the entity is reasonably certain to exercise that option
- Periods covered by an option to terminate if the entity is reasonably certain not to exercise that option
• Periods covered by an option to extend (or not to terminate) the hosting CCA service in which exercise of the option is controlled by the vendor

This assessment will need to be periodically reassessed to determine if the original amortization period is still reasonable. If the estimated amortization period changes, that change should be accounted for prospectively as a change in estimate.

Amortization should begin when any module or component of the hosted CCA service is ready for its intended use. The amortization start date is not based on the timing of when the overall hosted CCA service is placed in service unless the functionality of a module or component is entirely dependent on the completion of other modules/components.

**Example 1: Amortization period of implementation costs**

Entity A capitalizes $10 million in implementation costs related to a hosted CCA service. The initial term of the hosted CCA service is four years, with a customer option to renew for an additional two years.

Over what period should Entity A amortize the capitalized implementation costs?

**Analysis**

Entity A must first assess the likelihood of exercising its option to extend the hosted CCA service. If Entity A determines that it is at least reasonably certain it will exercise that option, the amortization period should be six years.

**Impairment**

Capitalized implementation costs should be assessed for impairment in a manner similar to long-lived assets. That is, entities should group capitalized implementation costs with other assets and liabilities at the lowest level for which identifiable cash flows exist independent of the cash flows of other assets and liabilities. Impairment is assessed when events or circumstances occur that indicate the carrying amount of the asset (asset group) may not be recoverable. The ASU includes a few examples of events or circumstances when entities should assess impairment of the capitalized implementation costs:

- The hosted CCA service is not expected to provide substantive service potential
- A significant change occurs in the extent or manner in which the hosting arrangement is used or is expected to be used
- A significant change is made or will be made to the hosting arrangement, including early termination

When an event or circumstance indicates the asset (asset group) may be impaired, entities will perform an impairment test by comparing the net carrying value of the asset (asset group) to the undiscounted net cash flows to be generated from the use and eventual disposition of that asset (asset group). Based on the results of the impairment test, entities may need to recognize an impairment loss.

If a hosted CCA service arrangement is being terminated early, the capitalized implementation costs should be treated like an asset being disposed of by abandonment. When applying this guidance, management should expense the capitalized implementation costs when the related hosted CCA service ceases to be used.
The new standard clarifies that the unit of accounting for abandonment is the capitalized implementation costs related to a module or component of the hosting arrangement. For example, if an entity terminates a module of the hosted CCA service but continues to use the hosted CCA service, only the terminated module should be considered abandoned.

**Presentation**

The guidance specifies the balance sheet, income statement, and cash flow presentation of capitalized implementation costs and the related amortization.

- Capitalized implementation costs should be classified in the same line item on the balance sheet as amounts prepaid for the hosted CCA service, if any (that is, generally as an other asset).
- Amortization of capitalized implementation costs should be presented in the same line on the income statement as the fees for the associated hosted CCA service. Accordingly, amortization should not be included with depreciation or amortization expense related to property, plant, or equipment or intangible assets.
- Cash flows related to capitalized implementation costs should be presented consistent with the presentation of cash flows for the fees related to the hosted CCA service, generally as cash flows from operations.

**PwC observation:**

Presentation requirements for capitalized implementation costs associated with hosted CCA services differ from the requirements for licensed internal-use software. Licensed internal-use software and the related implementation costs are classified as intangible assets, and the related cash flows shown as cash outflows from investing activities.

**Disclosure**

The new guidance requires the following disclosures for material capitalized implementation costs specifically related to a hosted CCA service:

- The nature of the entity’s hosting arrangements that are service contracts
- The disclosures required by ASC 360, *Property, Plant and Equipment*, as if the capitalized implementation costs were a separate major class of depreciable assets, including:
  - Amortization expense for the period
  - Balances of major classes of capitalized implementation costs, by nature or function, at the balance sheet date
  - Accumulated amortization, either by major classes of capitalized implementation costs or in total, at the balance sheet date
  - A general description of the method or methods used in computing amortization with respect to major classes of capitalized implementation costs
- In the event of an impairment of the implementation costs:
  - A description of the impaired asset (asset grouping) and the facts and circumstances leading to the impairment
○ If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement that includes that loss
○ The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)
○ If applicable, the segment in which the impaired long-lived asset (asset group) is reported under ASC 280, Segment Reporting

Certain additional disclosures are required in the period of adoption.

**Transition**

ASU 2018-15 is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted, including adoption in any interim period for which financial statements have not been issued. Entities can choose to adopt the new guidance (1) prospectively to eligible costs incurred on or after the date this guidance is first applied or (2) retrospectively.

**PwC observation:**

Entities that adopt prospectively will have to analyze costs incurred after the date of adoption to determine their nature and if they are capitalizable. If an entity has an ongoing implementation project, all costs incurred prior to the beginning of the interim period in which the new standard is adopted are expensed as incurred. If an entity wants to capitalize all costs related to that project, that entity would have to apply the retrospective method of transition.

Entities electing prospective transition approach are required to disclose, in the interim and annual periods of adoption, the nature of and reason for the change in accounting principle, the transition method and a qualitative description of the financial statement line items affected by the change.

Entities electing retrospective transition are required to disclose, in the first annual period after the entity’s adoption date and in the interim periods within the first annual period, the nature of and reason for the change in accounting principle, the transition method, a qualitative description of the financial statement line items affected by the change, and quantitative information about the effects of the change.

In reporting periods prior to adoption, SEC registrants should consider the disclosures required for standards that have been issued but are not yet effective (SEC Staff Accounting Bulletin No. 74).
To have a deeper discussion, contact:

Michael Coleman
Partner
Email: michael.coleman@pwc.com

Matthew Albert
Senior Manager
Email: matthew.j.albert@pwc.com

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