What is a cloud computing arrangement?

As companies move their data, applications, and platforms to the cloud, software products that have traditionally been installed locally on a customer’s server are now often hosted on a vendor’s server and accessed by the customer remotely. These arrangements are sometimes referred to as cloud computing arrangements (CCAs).

Even though the user’s functionality obtained from traditional licensed software may be similar to that of a CCA, the accounting treatment differs significantly. A software license is recorded as an asset on the purchaser’s books, while a CCA that does not include a software license is treated like other purchased services (i.e., expensed as incurred). New cloud computing guidance will result in the capitalization of certain costs to implement a CCA similar to the accounting for licensed software; however, there are key differences in the financial statement presentation.

What you need to know

- New cost guidance for cloud computing service arrangements is effective in 2020 for public business entities.
- Certain implementation costs will be capitalized and recognized over the arrangement term.
- Key metrics such as EBITDA could be impacted.

Access to software product
Customer obtains the right to access software product

Remote access to the software product
Software resides on the vendor’s or a third-party’s hardware, and the customer accesses the software remotely

Typical arrangements

Software as a service (SaaS)
Infrastructure as a service
Platform as a service
Accounting for implementation costs

A company can incur significant upfront costs to implement a CCA. While there is specific guidance on the accounting for costs related to software, there previously wasn’t any specific to implementation costs related to CCAs that are services. This has resulted in diversity in how companies accounted for costs related to CCAs. The FASB issued new guidance in August 2018 that requires companies to account for implementation costs related to CCAs using the same accounting rules as software that is licensed or developed for internal use. As a result, many implementation costs will be capitalized and recognized over the term of the CCA.

The new cloud computing guidance requires companies to present implementation costs related to a CCA in the same financial statement line items as the CCA service fees, resulting in key differences from the presentation of costs related to licensed software:

<table>
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<tr>
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<th>Licensed software</th>
<th>CCA service</th>
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<td>Balance sheet</td>
<td>Fixed or intangible asset</td>
<td>Prepaid or other asset</td>
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<td>Income statement</td>
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<td>Statement of cash flows</td>
<td>Investing activity</td>
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The presentation requirements could impact key metrics such as EBITDA because the recognition of CCA costs over time will not be included within depreciation or amortization expense. Companies should also consider the related impact to their budgeting and financial planning processes that may drive earnings guidance.

Getting started

The new cloud computing guidance is not optional—that means companies are required to track implementation costs related to a CCA and evaluate whether those costs should be capitalized. Other operational considerations and potential challenges include:

- Implementing new processes and controls for:
  - Tracking and evaluating costs
  - Determining amortization period
  - Assessing assets for impairment
  - Preparing disclosures

- Assessing implementation costs for each significant component or instance of a CCA, which may have different implementation timing and impairment considerations

- Evaluating activities performed by third-party service providers to identify or estimate the portion of costs that should be capitalized

- Considering impacts to areas outside of accounting, such as IT, financial planning, and income taxes
Next steps

The new cloud computing guidance is effective for calendar year-end public business entities in 2020, while all other entities have an additional year to adopt. Early adoption is permitted.

Companies can elect to adopt the new cloud computing guidance by retrospectively adjusting all prior periods presented in the financial statements. Alternatively, companies can elect to adopt on a prospective basis, in which case the new guidance will only be applied to eligible costs incurred after adoption. Companies that adopt when they are in the middle of an implementation project will want to balance the potential additional effort associated with retrospective adoption with the impact of adopting on a prospective basis, which could result in different accounting for costs incurred before adoption and costs incurred after adoption.

For more information, see In depth US2018-14, Cloud computing arrangements: Customer accounting for implementation costs and listen to our podcast.