Key accounting considerations for your cloud transformation journey

Accounting Advisory Services
Understanding the role you play in capitalizing on cloud value

Business leaders across the C-suite see cloud’s critical role in both defining and achieving their company’s growth and operational ambitions. However, from PwC’s US Cloud Business Survey, we learned that more than half (53%) of companies have yet to realize substantial value from their cloud investments—few companies are positioned for cloud to fully deliver on its exceptional promise.

While leaders from across the company play a critical role in cloud transformation, their roles will also change as the technology impacts their functions and the role they play within the business. And while business leaders agree that cloud is now both an integral part of corporate strategy and day-to-day operations, a cross-functional view is essential to capitalizing on cloud value.

Understand the cloud value gap—and four paths to close it

Cloud in its many forms is a critical enabler for broader business transformation. It helps connect systems, data, devices and emerging technology in ways that can help companies respond more quickly, agilely and innovatively. The majority of executives in our survey, 92%, say their companies are “all-in” on cloud or have adopted it in many parts of the business.

As such, cloud has become a rallying point for the C-suite. This unrealized value is significant, but it only begins to speak to cloud’s untapped potential to propel strategy. Those companies that use cloud as a springboard to truly change how they think, operate and do business can see even greater payoffs.

And this doesn’t start and stop with IT. A move to the cloud fundamentally changes how the business operates, which could have accounting and tax implications. There are many factors that need to be considered, as well as multiple groups within the organization that need to buy in.

Are you taking a holistic look at how cloud will impact your broader accounting and financial processes?
Understanding cloud’s impact on US GAAP accounting and financial reporting

Understanding how cloud technology impacts your broader accounting and financial reporting is critical to achieving your financial goals and getting the most ROI from your cloud investment. In the following, we will address some of the key accounting categories to consider as you progress through your cloud transformation journey:

1. Common accounting and financial metrics that are impacted

2. Costs that can be capitalized

3. Operational complexities

Previously, it was possible that certain implementation costs could be capitalized, as US GAAP did not specifically address the accounting for implementation costs of a hosting arrangement that is a service contract. Today, when managing services and applications in the cloud, companies now leverage the same guidance used for Internal Use Software to determine which costs may be deferred. Early awareness and communication can avoid misalignment of expectations between the accounting team and other stakeholders regarding this subtle but impactful change.

How traditional IT differs from cloud computing

<table>
<thead>
<tr>
<th>Traditional IT (On-premises)</th>
<th>Cloud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures for hardware and applications considered capital in nature</td>
<td>Yes</td>
</tr>
<tr>
<td>Flexible IT infrastructure</td>
<td>No</td>
</tr>
<tr>
<td>Built-in scalability</td>
<td>No</td>
</tr>
</tbody>
</table>

Accounting Implications

<table>
<thead>
<tr>
<th>Balance sheet classification</th>
<th>Property, plant &amp; equipment</th>
<th>Prepaid or other asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense classification</td>
<td>Amortization</td>
<td>Operating expense</td>
</tr>
<tr>
<td>Statement of Cash flow</td>
<td>Investing activity</td>
<td>Operating activity</td>
</tr>
<tr>
<td>Cost categorization</td>
<td>Capital-no impact to EBITDA</td>
<td>Operating-reduces EBITDA</td>
</tr>
</tbody>
</table>

How cloud impacts common accounting and financial metrics

<table>
<thead>
<tr>
<th>Key Metric</th>
<th>Licensed software</th>
<th>Cloud Computing Arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation and amortization</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td>EBITDA</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td>Net debt to EBITDA ratio</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Current Assets</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Operating cash flows</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td>Investing cash flows</td>
<td>↓</td>
<td>↑</td>
</tr>
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</table>

[1] This publication is written under US GAAP. There may be differences when moving to the cloud under IFRS that are not addressed in this publication.

[2] Earnings before interest, tax, depreciation, and amortization
Types of cloud service models

With new guidance, clarifies the accounting treatment of implementation costs for cloud service models. Several questions arise as to what types of models are scoped into to these accounting rules and costs qualify for deferral versus expensing. Part of the challenge is the accounting rules being applied to such models is consistent with previous guidance regarding internal-use software which dates back to the nineties but the variations and complexities of the different cloud service models have continued to evolve. Let’s explore some common examples.

Types of cloud service models

- **Software as a service (SaaS)** is on-demand access to ready to use cloud-hosted application software managed by a third-party vendor.

- **Platform as a service (PaaS)** is on-demand access to a complete, ready-to-use, cloud-hosted platform for developing, running, maintaining and managing applications. It involves a third party providing a framework for a team of software developers to create and manage customized applications.

- **Infrastructure as a service (IaaS)** is on-demand access to cloud-hosted physical and virtual servers, storage and networking and involves a third party providing on-demand, self-service access to highly scalable and automated computing resources.

Right to use software or hardware

If the cloud service model includes a software license that the customer has the option to take possession of, the license is within the scope of internal-use software guidance (ASC 350-40). This addresses which costs should be capitalized, including the cost to acquire the license and the related implementation costs.

Remote access: Computing resources reside on the vendor’s or a third party’s hardware

If the cloud service model does not include a software license, the arrangement is considered a service contract. Implementation costs may qualify for capitalization based on the phase and nature of the costs.

What costs can be capitalized or deferred?

<table>
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<tr>
<th>Potentially capitalizable</th>
<th>Generally not capitalizable</th>
</tr>
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<tbody>
<tr>
<td>External direct costs of materials</td>
<td>Preliminary project planning and post-implementation costs</td>
</tr>
<tr>
<td>Third-party service fees to develop the software</td>
<td>Costs for data conversion activities</td>
</tr>
<tr>
<td>Cost to obtain software from third parties</td>
<td>Costs for training activities</td>
</tr>
<tr>
<td>Coding &amp; testing fees directly related to software product</td>
<td>Software maintenance costs</td>
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Once you have determined the scope, type of cloud service model and software development process, determining which operational aspects of the software implementation activities are eligible for capitalization requires judgment and an analysis of the nature of the costs incurred. As discussed earlier, this can be particularly challenging in an agile environment. Addressing the operational challenges that could influence which implementation activities are eligible for capitalization may involve:

<table>
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<tr>
<th>Operational challenges</th>
<th>Actions to consider</th>
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| Determining which activities qualify for capitalization versus expense treatment. | • Assess the nature of the costs incurred  
• Identify direct labor, incentive compensation, engineering costs, and meals & entertainment costs.  
• Segregate costs for a solution that has multiple components, such as on-premises equipment, cloud solutions, hardware, software, third-party vendors. |
| Addressing operational complexities that may arise from agile software development. | • Consider challenges for a sprint vs storyboarding approach and the respective governance approach for each.  
• Design a process to identify, evaluate and account for unsuccessful sprints. |
| Assessing the accounting for implementation costs with multiple modules or components. | • Determine the value of multiple instances of the same hosted cloud service used for different business units (which could be in different stages of implementation).  
• Determine when amortization should begin for each module or component of the hosted cloud service. |
| Evaluating cloud service provider arrangements to determine which fees represent implementation costs. | • Estimate and value the portion of the fee that relates to the implementation services to apply the new guidance to these costs. The cloud service provider may not always separate the fees for implementation services from the fees for the hosted cloud service; instead, there may be a single monthly payment stream for all services. |
| Assessing cross-functional arrangements. | • Account for data migration and integration into other systems.  
• Develop approaches/methods for educating developers/engineers on accounting considerations (i.e. framework). |
Operational complexities to consider

To assist in addressing these challenges, companies can use this as an opportunity to leverage technology through process automation. Visualization tools can be used to simplify and track the end to end process for data already captured today, or tracked specifically for project purposes. By leveraging existing technology and embracing process automation, business decisions can be made quicker, with real-time information, leading to more efficient processes and comprehensive outcomes related to accounting treatments and technology solutions.

Additionally, a cloud computing contract may require application of multiple accounting standards—many of which have also recently changed. In these situations, companies need to consider whether costs, which would otherwise have been within the scope of the updated cloud computing standard, are accounted for using a different standard. For example, if the arrangement includes an explicit or embedded lease (e.g. dedicated equipment/servers), the company would need to determine which costs are accounted for under ASC 842, versus the new cloud computing standard.
How a shift from waterfall to agile delivery also impact accounting and financial reporting

Current technology and software development processes now largely follow an agile development life cycle. With agile software development, requirements and solutions—including many involving CCA arrangements—evolve through collaboration among self-organizing, cross-functional teams. These methods have many advantages for the business, including the ability to implement changes on a quicker timeline.

An agile method, however, has accounting complexities compared with a linear model as the existing accounting were developed based on the linear model. In a linear model, projects follow defined stages, which largely drive the accounting for costs incurred. In the agile model, projects do not follow the same stages and therefore tracking the details of costs incurred is more important.

Consider the following questions when assessing the accounting for arrangements following agile development:

• How are you tracking costs both internal and external incurred throughout the project lifecycle? Ensure enough detail is being captured to analyze what costs represent

• What is the unit of account for costs eligible for capitalization?

• Many cloud service models may have multiple modules/components, so how are you determine the value for each the amortization for each module?
Accounting for cloud when optimizing for other GAAP changes

Many companies have also recently implemented the new revenue recognition and lease accounting standards. As part of this journey, many are exploring technology solutions to automate and optimize. A cloud implementation can drive accounting changes and create significant efficiencies. Additionally, leveraging the processes used to adopt these significant standards and cloud capabilities, companies can also maximize the ESG efforts. Specifically, regarding processes and technologies that enable efficient and transparent initial and ongoing ESG reporting. This may be achieved by various digital accelerators including artificial intelligence and machine learning capabilities.

It’s important to understand that the new cloud computing standard could significantly impact the recognition of costs for the implementation. Additionally, incorporating new automation systems requires a front-loaded investment to select new systems and get them up and running.

To the extent that companies are implementing a cloud transformation as part of other accounting change initiatives, they should also ensure they have the right processes and governance to address new standards.
How PwC can help

PwC has deep expertise in helping clients in navigating the broad challenges that accompany a business transformations. Our teams can assist with financial reporting questions, as well as the broader business and tax implications. The assistance we can provide includes:

• Accounting analysis regarding capitalization and disclosures.
• Help with data, controls, and processes during both implementation and go-live.
• Analysis of the tax impacts of recent accounting changes and how to improve tax positions.
• Implementing cloud platforms & solutions and related performance management mechanisms.

Contact one of our professionals to have a deeper conversation about your organization’s challenges with recent accounting changes and how we can be of assistance.

Contact us

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