

Proposed Accounting Standards Update

Issued: August 20, 2014
Comments Due: November 18, 2014

Intangibles—Goodwill and Other—
Internal-Use Software (Subtopic 350-40)

Customer's Accounting for Fees Paid in a
Cloud Computing Arrangement

This Exposure Draft of a proposed Accounting Standards Update of Subtopic 350-40 is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. 2014-230

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by November 18, 2014. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing a written letter to director@fasb.org, File Reference No. 2014-230
- Sending written comments to “Technical Director, File Reference No. 2014-230, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Do not send responses by fax.

All comments received are part of the FASB’s public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

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Proposed Accounting Standards Update

Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40)

Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update) and What Are the Main Provisions?

The Board is issuing the amendments in this proposed Update as part of a Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of the financial statements.

GAAP does not include explicit guidance about a customer's accounting for fees paid in a cloud computing arrangement. Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service, and other similar hosting arrangements. The Board has heard from stakeholders that the absence of explicit guidance results in some diversity in practice as well as unnecessary cost and complexity for some stakeholders that evaluate the accounting for those fees.

The Board proposes to add guidance to Subtopic 350-40, Intangibles—Goodwill and Other—Internal-Use Software, that would help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. The proposed guidance already exists in the Codification in paragraphs 985-605-55-121 through 55-123, but it is included in a Subtopic applied by cloud service providers to determine whether an arrangement includes the sale or license of software.

The amendments in this proposed Update would provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer would account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer would account for the arrangement as a service contract. The proposed guidance would not change GAAP for a customer's accounting for software licenses or service contracts.

What Are the Transition Requirements and When Would the Amendments Be Effective?

For public business entities, the Board expects that the proposed amendments would be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. For all other entities, the

proposed amendments would be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption would be permitted for all entities.

An entity would elect to adopt the proposed amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. For prospective transition, the only disclosure requirements at transition would be 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. For retrospective transition, the disclosure requirements at transition would include the requirements for prospective transition and quantitative information about the effects of the accounting change.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Should a customer in a cloud computing arrangement evaluate whether the arrangement involves a software license by applying the criteria in paragraphs 350-40-15-4A through 15-4C? If not, what guidance should be applied and why?

Question 2: Should an entity be permitted to elect prospective or retrospective transition?

Question 3: Should the amendments in this proposed Update be effective for:

- a. Public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015, with early adoption permitted?
- b. All other entities for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016, with early adoption permitted?

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–4. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 350-40

2. Add the following existing Master Glossary term to Subtopic 350-40, as follows:

Hosting Arrangement

In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

3. Amend paragraph 350-40-15-4 and add paragraphs 350-40-15-4A through 15-4C, with a link to transition paragraph 350-40-65-1, as follows:

Intangibles—Goodwill and Other—Internal-Use Software

Scope and Scope Exceptions

> Transactions

350-40-15-4 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process, subject to Subtopic 985-20
- b. Software to be used in research and development, subject to Subtopic 730-10
- c. Software developed for others under a contractual arrangement, subject to contract accounting standards

- d. Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications.
- e. Software that a customer obtains access to in a **hosting arrangement** that does not meet the criteria in paragraph 350-40-15-4A.

350-40-15-4A The guidance in this Subtopic only applies to internal-use software that a customer obtains access to in a **hosting arrangement** if both of the following criteria are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

350-40-15-4B For purposes of the guidance in paragraph 350-40-15-4A(a), the term *without significant penalty* contains two distinct concepts:

- a. The ability to take delivery of the software without incurring significant cost.
- b. The ability to use the software separately without a significant diminution in utility or value.

350-40-15-4C Hosting arrangements that do not meet both criteria in paragraph 350-40-15-4A are service contracts and do not constitute a purchase of, or convey a license to, software.

- 4. Add paragraph 350-40-65-1 and its related heading as follows:

**> Transition Related to Accounting Standards Update No. 2014-XX,
Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40):
Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement**

350-40-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2014-XX, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*:

- a. For **public business entities**, the pending content that links to this paragraph shall be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015.
- b. For all other entities, the pending content that links to this paragraph shall be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016.
- c. Early application of the pending content that links to this paragraph is permitted by all entities.

- d. The pending content that links to this paragraph may be applied either prospectively to all arrangements entered into or materially modified after the effective date or retrospectively.
- e. A public business entity that elects prospective transition shall disclose in the first interim period and annual period after the effective date the following:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The transition method
 - 3. A qualitative description of the financial statement line items affected by the change.
- f. A public business entity that elects retrospective transition shall disclose in the first annual period after the entity's adoption date, and in the interim periods within the first annual period, the following:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The transition method
 - 3. A description of the prior-period information that has been retrospectively adjusted
 - 4. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item(s), and any affected per-share amounts for the current period and any prior periods, retrospectively adjusted
 - 5. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
- g. All other entities shall make the disclosures in (e) and (f) for prospective transition or retrospective transition, as applicable, in the first annual period after the entity's adoption date, unless the entity elects to early adopt the pending content that links to this paragraph in an interim period, in which case the entity also shall make those disclosures in the interim periods within the first annual period after the entity's adoption date.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board is issuing the amendments in this proposed Update as part of a Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of the financial statements.

Reasons for Proposed Amendments

BC3. The Board is proposing to add guidance to Subtopic 350-40 to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service, and other similar hosting arrangements. The guidance in this proposed Update would provide a basis for evaluating whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a license to internal-use software, then the software license would be accounted for by the customer in accordance with Subtopic 350-40. A license to software other than internal-use software would be accounted for under other applicable GAAP (for example, software to be used in research and development would be accounted for in accordance with Subtopic 730-10, Research and Development—Overall). If a cloud computing arrangement does not include a software license, then the arrangement would be accounted for as a service contract. Some arrangements may include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s). The proposed guidance does not change GAAP for a customer's or a vendor's accounting for software licenses or service contracts.

BC4. The proposed guidance already exists in the Codification, but it is included in a Subtopic applied by cloud service providers to determine when an arrangement includes the sale or license of software. The guidance is included in paragraphs 985-605-55-121 through 55-123 in Subtopic 985-605, Software—

Revenue Recognition. The Board is proposing to use language that is nearly identical to the guidance applied by cloud service providers in the amendments in this proposed Update because the Board wanted to use language that was already applied in practice. The guidance applied by cloud service providers is understood and has been applied in practice for many years. The guidance in FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, amends the Codification by moving the guidance applied by cloud service providers to determine whether an arrangement is for the sale or license of software or the provision of services to Subtopic 985-20, Software—Costs of Software to Be Sold, Leased, or Marketed.

Effective Date and Transition

BC5. The Board expects that the amendments in this proposed Update would be effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015, and for all other entities for the first annual period beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016.

BC6. The effective date will depend on feedback from stakeholders on the amendments in this proposed Update and the issuance date of final guidance.

BC7. The Board is proposing to allow entities to early adopt the amendments in this proposed Update because the proposed amendments represent an improvement to GAAP that should reduce costs and complexity for preparers that are customers in cloud computing arrangements.

BC8. The Board is proposing that a reporting entity may elect retrospective or prospective transition. Under prospective transition, an entity would apply the guidance in this proposed Update to all arrangements entered into or materially modified after the effective date. The Board is proposing that the benefits of retrospective transition may not justify the costs because the effect of retrospective application is not expected to be significant for those entities that would change their accounting as a result of the proposed amendments. However, the Board saw no reason to prohibit an entity from retrospectively applying the proposed amendments because it believes that the proposed amendments should improve comparability between the financial statements of different preparers.

BC9. The Board is proposing that if an entity elects prospective transition, then the entity should disclose 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. The Board decided in making this proposal that the benefits of requiring quantitative disclosure of the effect of the proposed amendments would not justify the costs. The Board acknowledges that the amendments in this proposed Update may result in some entities changing their accounting for cloud computing arrangements; however, the change is not

expected to be significant for the minority of entities that are required to change their accounting. If an entity elects retrospective transition, then the entity should disclose the requirements for prospective transition and some quantitative information about the effects of the change on specified reported items. The transition disclosures would be in place of those required in paragraphs 250-10-50-1 through 50-3.

Benefits and Costs

BC10. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC11. The amendments in this proposed Update would reduce cost and complexity because the lack of explicit guidance about a customer's accounting for fees paid in a cloud computing arrangement causes some entities to incur costs to evaluate that accounting. In addition, the amendments in this proposed Update for determining whether a cloud computing arrangement includes a software license is already applied and understood in practice by cloud service providers.

BC12. The amendments in this proposed Update would increase the consistency of accounting for cloud computing arrangements among entities.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). We welcome comments on these proposed changes to the UGT through [ASU Taxonomy Changes](#) provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the UGT will be made available for public comment at www.fasb.org and finalized as part of the annual release process.