

MEMO

Memo No. **Issue Summary No. 1, Supplement No 2***

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Meeting Date(s) **EITF October 12, 2017**

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Project	Issue No. 17-A, "Customer's Accounting for Implementation, Setup, and Other Upfront Costs (Implementation Costs) Incurred in a Cloud Computing Arrangement That Is Considered a Service Contract"		
Project Stage	Initial Deliberations		
Date previously discussed by EITF	July 20, 2017		
Previously distributed Memo Number	Issue Summary No. 1, dated July 7, 2017		

Memo Purpose

1. The purpose of this Issue Summary Supplement is to provide Task Force Members the original Alternative C of Issue 3 as described in paragraphs 102 through 108 of Issue Summary No. 1, and Appendix A of that Issue Summary, which were discussed at the July 20, 2017 meeting. The Task Force may consider this alternative in addition to the other alternatives described in Issue Summary Supplement No. 1 for Issue 1, *Accounting for Implementation Costs Incurred in a CCA That Is Considered a Service Contract*.

*** The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Alternative C of Issue 3 as Described in Issue Summary No. 1

Alternative C—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Considered the Same as Implementation Costs Associated with a Software License.

2. Under Alternative C, an entity would account for implementation costs incurred in a CCA in a manner consistent with implementation costs when a software license is acquired under Subtopic 350-40. Under Alternative C, an entity would expense those costs that are incurred in the preliminary project and post-implementation-operation stages. Costs incurred for setup fees should be accounted for in accordance with guidance on prepaid assets in Topic 340, or other relevant guidance. Costs incurred for integration with on-premise software, coding, and configuration or customization are capitalized as intangible assets. Those costs incurred for data conversion and training are expensed as incurred. Any costs for business process reengineering would be accounted for in accordance with Subtopic 720-45.
3. For upgrades and enhancements, costs incurred would be capitalized if they resulted in additional functionality. Internal costs for upgrades and enhancements would be capitalized or expensed in accordance with the application development costs in the proposed paragraphs 350-60-25-2 through 350-40-25-6. Any maintenance costs should be expensed as incurred.
4. Proponents of Alternative C assert that the implementation costs for CCAs that are service contracts are economically similar to those incurred in an on-premise solution and, therefore, the accounting for implementation costs should be consistent. Proponents of Alternative C also explained that preparers do not have a difficult time using the guidance in Subtopic 350-40 for implementation costs for a software license. Therefore, they do not think it makes sense to create a new model, such as that under Alternative B, which may be more difficult for preparers to implement. These stakeholders preferred to treat the implementation costs the same even though that may result in capitalizing implementation costs related to an overall arrangement that is not an intangible asset.
5. Proponents of Alternative C supported extending the guidance that requires capitalization of direct and incremental costs necessary to get the software ready for the entity's intended use to CCAs that are accounted for as service contracts.
6. Opponents of Alternative C highlighted conceptual concerns with allowing for capitalization of costs in situations in which the entity does not have control of an asset. Based on the Board decisions made in Update 2015-05, those arrangements that do not meet both criteria in paragraph 350-40-15-4A are accounted for as service contracts and do not constitute a purchase of, or convey a license to, software. In other words, the FASB decided that the

underlying arrangements (license or service contract) were not to be accounted for in the same manner. They were concerned the costs could be treated in the same manner because the underlying arrangement in a service contract is not an asset. Opponents also were concerned that Alternative C essentially unwinds the conceptual basis of Update 2015-05 and some stakeholders may eventually assert that the criteria and model introduced therein would need to be reevaluated to possibly allow for capitalization of the overall CCA as an intangible asset. Opponents of Alternative C also note that this model would be a significant change in practice for many preparers today who have CCAs that are service contracts, and who have sought to apply the other GAAP described in Alternative B. They also think it would raise significant concerns about the accounting for other service contracts.

7. Opponents of Alternative C think that if the accounting for implementation costs was the same as the accounting for software on the basis that the arrangements are economically similar, then the accounting for the underlying arrangement (that is, the CCA) should be the same as the accounting for software. This would mean that the CCA would be recognized as an asset and that a corresponding liability for hosting fees paid over time also would be recognized. However, they note that approach would be inconsistent with the Board's decisions and basis in Update 2015-05.
8. Additionally, opponents of this Alternative said that the guidance in Subtopic 350-40 is outdated, and that the phases outlined in paragraphs 350-40-25-1 through 350-40-25-11 do not truly represent the current process of acquiring a software license. Some preparers asserted to the staff that Subtopic 350-40 can be difficult to apply today. Lastly, opponents assert that the boundary lines in the phases (preliminary project, application development, and post-implementation-operation) are not as structured in the context of a CCA that is a service contract and, if the Task Force were to choose Alternative C, revisions would likely need to be made to update the existing guidance to ensure the guidance would be suitable for CCAs that are considered service contracts.

Appendix A of Issue Summary No. 1

This example illustrates how an entity might apply the guidance under Alternative B and Alternative C, to particular aspects of the implementation costs incurred when acquiring a CCA on the basis of the limited facts presented.

Facts

Customer engages Vendor to provide hosting services as part of a CCA that does not include a software license in accordance with paragraph 350-40-15-4A. The arrangement will provide Customer with a customer relationship management database solution that will provide real-time customer information from various internal systems. The components of this arrangement include (1) creation of interfaces between the database and source systems; (2) coding and customizing the Customer's on-premise licensed software to meet the needs of Customer; and (3) hosting services.

The hosting arrangement is for a term of five years with renewal options.

The costs expected to be incurred by Customer (vendor, internal, and third-party consulting costs) include:

- Preliminary project stage costs
 - Conceptual formulation of alternatives, evaluation of alternatives, determination of existence of needed technology, final selection of alternatives, selection of vendor
- Application development costs
 - Internal and external costs incurred to integrate the software that a customer obtains access to in a hosting arrangement that is considered a service contract with the customer's internal-use computer software
 - Data conversion costs
 - reconciling new data with the data extracted from an old system
 - purging existing data
 - creating or inputting new data
 - Installation of hardware
 - Architecture and design costs (configuration of vendor's and customer's software, financial data modeling)
 - Coding costs (vendor's and customer's software)
 - Testing costs
 - Training costs, including parallel phases
 - Travel expenses incurred by employees
 - Business process reengineering
- Post implementation-operation stage costs
 - Internal and external training costs
 - Ongoing maintenance costs
- Upgrades and enhancements to the vendor's or customer's software to make modifications or to add functionality

Staff note: The following table should not be considered an interpretation of current GAAP. This table is intended for illustrative purposes to facilitate the EITF's consideration of the different accounting alternatives to be discussed at the July 20, 2017 EITF meeting.

Type of Implementation Cost	Alternative B	Alternative C
Preliminary project stage	Expense as incurred	Expense as incurred
Application development stage	<u>Integration with on-premise software</u> – capitalize, if it benefits on-premise software	<u>Integration with on-premise software**</u> – capitalize
	<u>Installation of hardware</u> – capitalize in accordance with Topic 360	<u>Installation of hardware</u> – capitalize in accordance with Topic 360

Type of Implementation Cost	Alternative B	Alternative C
	<u>Coding</u> – capitalize if it benefits on-premise software. Expense if it is vendor’s software (unless it is not distinct from hosting)	<u>Coding*</u> – capitalize
	<u>Configuration / customization (Customer’s system)</u> – capitalize, if it benefits on-premise software	<u>Configuration / customization (Customer’s system)</u> – capitalize
	<u>Configuration / customization (Vendor’s system)</u> – expense if distinct from hosting; prepaid if not distinct from hosting.	<u>Configuration / customization (Vendor’s system)</u> – probably capitalize
	<u>Travel expenses</u> – expense as incurred	<u>Travel expenses</u> - capitalize
	<u>Data conversion</u> – generally expense as incurred (Capitalize if developing software to do conversion)	<u>Data conversion</u> – generally expense as incurred (Capitalize if developing software to do conversion)
	<u>Training</u> – expense as incurred	<u>Training</u> – expense as incurred
	<u>Business process reengineering</u> – expense as incurred in accordance with Subtopic 720-45	<u>Business process reengineering</u> – expense as incurred in accordance with Subtopic 720-45
Post-implementation-operation stage	Expense as incurred	Expense as incurred
Upgrades and Enhancements	<u>Specified upgrades and enhancements</u> – capitalize if it results in additional functionality to on-premise software, otherwise expense	<u>Specified upgrades and enhancements</u> – capitalize if it results in additional functionality
	<u>Internal costs for upgrades and enhancements</u> - capitalize or expense internal costs in accordance with the accounting for the application stage development costs in proposed paragraphs 350-60-25-2 through 350-40-25-6	<u>Internal costs for upgrades and enhancements</u> - capitalize or expense internal costs in accordance with the accounting for the application stage development costs in proposed paragraphs 350-60-25-2 through 350-40-25-6
	<u>Maintenance</u> – expense as incurred	<u>Maintenance</u> – expense as incurred

** These are illustrative examples of “internal and external costs to develop or obtain internal-use computer software during the application development stage,” which is the language utilized in paragraph 350-40-25-2.