FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO	Memo No.	**Issue Summary No. 1, Supplement No 3***
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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; October 12, 2017**
Previously distributed Memo Numbers	**Issue Summary No. 1, dated July 7, 2017; Issue Summary No. 1, Supplements Nos. 1 & 2, dated September 28, 2017 & September 29, 2017, respectively**

Memo Purpose

1. At the July 20, 2017 and October 12, 2017 EITF meetings, the Task Force discussed the primary accounting question related to this Issue, which is how a customer should account for implementation, setup, and other upfront costs (referred as implementation costs) incurred in a cloud computing arrangement (CCA) that is considered a service contract. At the October 2017 meeting, the Task Force reached a tentative conclusion on the primary accounting question (Issue 1); however, the Task Force requested that the staff perform additional research to determine how a customer in a CCA would measure the asset and liability that would be recognized for the software element of a hosting arrangement under the Task Force's tentative conclusion.

* **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.**

2. The purpose of this memo is to update the Task Force on the additional research that the staff has performed, present alternatives based on that research, and present for discussion the remaining accounting questions that have not yet been addressed by the Task Force.

Background

3. In April 2015, the FASB issued Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, to help entities evaluate the accounting for fees paid by a customer in a CCA by providing guidance for determining when the arrangement includes a software license. Examples of CCAs include software as a service (SaaS), platform as a service (PaaS), infrastructure as a service (IaaS), and other similar hosting arrangements. A SaaS arrangement uses internet-based application software hosted by a service provider or third party (other than the service provider) and is the most common type of CCA.

4. If a CCA includes a license to internal-use software, then the software license is accounted for by the customer in accordance with Subtopic 350-40, *Intangibles—Goodwill and Other—Internal-Use Software*. This generally means that an asset is recognized for the software license, and, to the extent that the payments attributable to the software license are made over time, a liability also is recognized. If a CCA does not include a software license, the entity should account for the arrangement as a service contract. This generally means that the hosting fees are expensed as incurred.

5. After Update 2015-05 was issued, several stakeholders requested that the Board provide additional guidance on the accounting for costs for implementation activities incurred in a CCA that is considered a service contract. Because of the lack of clear guidance in GAAP, those stakeholders observed that entities have used various areas of the Codification for additional guidance, which has resulted in diversity in practice.

6. On May 10, 2017, the Board decided to add a narrow scope project to the EITF's agenda to address a customer's accounting for costs for implementation activities incurred in a CCA that is considered a service contract.

7. The following issues were included in Supplement No. 1, based on the issues originally included in Issue Summary No. 1:

    Issue 1: Accounting for Implementation Costs Incurred in a CCA That Is Considered a Service Contract (tentative decision reached at the October 2017 meeting)

    Issue 2: Amortization Period (discussed, but no decision reached, at the July 2017 meeting)

Issue 3: Definition of Implementation Costs (tentative decision reached at October 2017 meeting)

Issue 4: Scope of the Project (not yet discussed)

Issue 5: Analogy to Other Service Contracts (not yet discussed)

8. If the Task Force reaches a consensus on these issues, the staff also will present questions for discussion on disclosures and transition.

Issues

Issue 1 – Accounting for Implementation Costs Incurred in a CCA That Is Considered a Service Contract

Summary of Previous Tentative Conclusions and Task Force Deliberations

9. At its October 2017 meeting, the Task Force considered the following three alternatives to account for the costs incurred for implementation activities in a CCA that is considered a service contract.

Alternative B— Implementation costs associated with a CCA that is considered a service contract would be recognized as an asset or an expense when incurred on the basis of existing GAAP. Implementation costs that are not addressed by existing guidance would be expensed as incurred if the related activities are considered distinct from the hosting service (based on Topic 606) or capitalized as a prepaid asset for the services if the related activities are not distinct (based on Topic 606).

Original Alternative C—Implementation costs associated with a CCA that is considered a service contract would be accounted for the same as implementation costs associated with a software license

Revised Alternative C—All hosting arrangements (as defined in the Master Glossary) would be within the scope of Subtopic 350-40

10. Two other alternatives were presented to the Task Force at the July 2017 EITF meeting. These alternatives included Alternative A, which would have required that all implementation costs be expensed as incurred, and Alternative C^1, which would have required an entity to analogize to Topic 360, Property, Plant, and Equipment, in order to account for implementation costs. At the July 2017 EITF meeting, Task Force members did not express support for either Alternative A or Alternative C^1. Consequently, the staff did not present either of these alternatives at the October 2017 EITF meeting.

11. At its October 2017 meeting, the Task Force reached a tentative conclusion to align the accounting for all CCAs, wherein all CCAs would include a software element that would be within the scope of Subtopic 350-40 (that is, Revised Alternative C). Revised Alternative C would require an entity to identify a software element in all of its hosting arrangements, as defined in the Master Glossary of the Codification; that software element would be within the scope of Subtopic 350-40. Since the software element would be within the scope of Subtopic 350-40, it would be capitalized and the implementation costs to get that software element ready for its intended use and that are capitalizable under Subtopic 350-40 also would be capitalized as part of the cost of the software element. A liability would be recognized for the present value of any fees in the CCA related to the software element that are not paid at contract commencement. The staff also suggested that the Task Force could provide a practical expedient under Revised Alternative C that would allow entities not to separate the hosting service from the software element. Revised Alternative C would address the inconsistencies between Original Alternative C and Update 2015-05 by proposing new amendments that would change the conclusions in Update 2015-05.

12. In evaluating Revised Alternative C, one Task Force member and one Board member questioned whether the term *hosting arrangement*, as defined in the Master Glossary, would cause some hosting arrangements to fall out of the scope of Revised Alternative C because that definition uses the term *license*. They therefore suggested updating the definition of hosting arrangement to avoid any unintended scope restrictions. One Task Force member noted that executory contracts that have a minor software element in the contract might be within the scope of Revised Alternative C, and, accordingly, that Revised Alternative C might have unintended consequences related to executory contracts in general. When comparing Revised Alternative C with Original Alternative C, some Task Force members discussed the executory nature of hosting arrangements and how there is a lack of well-defined accounting guidance for executory contracts. Some Task Force members and one Board member noted that Revised Alternative C would effectively treat CCAs like leases under Topic 842, but that Topic specifically scopes out leases of intangible assets from its guidance. A Task Force member and a Board member therefore questioned whether other intangible assets should be addressed if the Task Force proposes to treat CCAs like leases. It also was noted that Revised Alternative C was the only alternative that would align the accounting for CCAs that are considered service contracts with that of on-premise software licenses.

13. The Task Force also discussed the practical questions under Revised Alternative C related to the capitalization of the software element of a hosting arrangement, such as how to consider renewal and termination options, what discount rate to use, and how to account for variable payments. The Task Force discussed the extent to which the guidance in Topic 842, Leases, would apply to CCAs if the Task Force were to permit use of that guidance by analogy. The

FASB staff clarified that only specific aspects of the guidance in Topic 842 would apply to CCAs if the Task Force were to permit use of the leases guidance by analogy. For example, by making an analogy to a lease, a customer in a CCA would apply the guidance in Topic 842 to account for variable payments or to evaluate extension or termination options included in the arrangement, but the customer would not be required to assess lease classification and the customer would not be required to provide all disclosures included in Topic 842. The staff also clarified that implementation costs would not be accounted for as initial direct costs under Topic 842.

14. At the October 2017 EITF meeting, some Task Force members supported analogizing to certain aspects of Topic 842, but other Task Force members and some Board members preferred obtaining a better understanding of how practice currently applies the guidance in Subtopic 350-40 to on-premise software licenses before determining whether analogizing to Topic 842 is necessary. The Task Force also requested that the staff perform additional research on how certain aspects of Topic 842 would apply to the accounting for hosting arrangements. One Task Force member observed that the guidance applicable to discount rates in Topic 842 would not apply to the software element of a hosting arrangement because, under Topic 842, the incremental borrowing rate is determined on a collateralized basis. While the staff proposed an analogy to a finance lease, one Board member also questioned whether an analogy should be made to an operating lease.

15. The Task Force ultimately directed the staff to perform research in the following areas:

   a) Determine whether there currently is diversity in practice in accounting for on-premise software under Subtopic 350-40, including how entities assess variable payments, discount rates, and renewals for internal-use software.

   b) Determine how the accounting for on-premise software under Subtopic 350-40 may change if an analogy to (or alignment with) Topic 842 were to be made for hosting arrangements.

   c) Evaluate whether the capitalized software element of a hosting arrangement is more appropriately analogized to an operating lease or to a finance lease.

   d) Analyze the disclosure requirements in Topic 842 and assess whether any of those requirements would be applicable to hosting arrangements.

Research and Stakeholder Outreach

16. Following the October 2017 EITF meeting, the staff performed outreach with six accounting/consulting firms in addition to three preparers and one preparer/vendor. The outreach focused on answering the previously mentioned research questions. In addition to outreach, the staff performed research using XBRL data and searching through 10-K filings.

The summary of findings for the first three research questions is located in this subsection. For research findings related to the disclosure requirements of Topic 842, refer to the disclosure section of this Issue Summary Supplement on page 28.

Accounting for On-Premise Software Licenses in Current Practice and Effect of Applying Topic 842

17. The FASB staff performed research to determine whether there currently is diversity in practice in accounting for on-premise software under Subtopic 350-40, including how entities assess variable payments, discount rates, and renewals for internal-use software. The staff research included reviewing the Big 4 firms' accounting guidance, which the staff noted did not include any guidance on these areas. The staff's research also included compiling and reviewing accounting policies tagged with the internal-use software or intangible asset accounting policy elements in XBRL filings and performing 10-K filing searches for terms related to variable payments, discount rates, and renewals for internal-use software.

18. Based on its research, the staff noted that certain entities disclosed that costs to renew intangible assets, including fees to renew term licenses of software, are capitalized when incurred and amortized over the remaining useful life of the asset. Certain entities also disclosed that variable payments (and a related liability, if necessary) are accrued when they are determined to be probable. Although certain entities provided these disclosures, the staff noted that most entities did not disclose policies for renewals and variable payments. This could be because many entities' internal-use software does not include variable payments and includes a perpetual license instead of a term license or is developed internally. This also could be because the effect of these items is not material to those entities' financial statements. No entity disclosed how it determined a discount rate for a liability recognized for payments to be made over time for software.

19. The staff noted that the decision as to whether renewals should be capitalized would most significantly affect the period over which implementation costs would be amortized. The staff noted that many entities disclosed that software-related costs are amortized over the lesser of the estimated useful life of the software or the term of the software license. If renewals are not included in the initial software-related costs, then implementation costs would be amortized over the initial (noncancelable) term of the license.

20. In general, the feedback received from outreach participants confirmed the initial research findings of the FASB staff. The outreach indicated that entities generally do not capitalize variable payments until they are probable of occurring and do not capitalize renewals for term licenses at contract commencement. However, one accounting firm noted that they were aware of situations in which renewal options were capitalized at contract commencement. Another participant indicated that estimated variable payments are capitalized at contract

commencement. Outreach participants also indicated that the amortization period of implementation costs typically is the initial term of the license.

21. It should be noted that there are limitations inherent in researching the treatment of these features under current practice. Outreach participants indicated that term licenses for on-premise software, particularly with these types of features, are less common. Many software vendors sell perpetual licenses that are paid for upfront. As a result, there are fewer instances in which companies are currently accounting for renewals and payments made over time. Based on the outreach performed, these features are more common in CCAs. By bringing all CCAs into the scope of Subtopic 350-40, the number of preparers impacted by the measurement of software with these types of features would increase and may create a need for new guidance.

22. The outreach did not identify other types of features of CCAs in which outreach participants indicated guidance would be necessary. However, if the Task Force reaches a consensus on this Issue, the staff may provide certain clarifications on the application of the guidance in Subtopic 350-40 to CCAs (for example, impairment) while drafting the proposed Codification amendments.

23. The staff also performed outreach on the effect of applying the guidance for renewals, variable payments, and discount rates in Topic 842 to CCAs and on-premise software. A comparison of how these features appear to be accounted for under current practice (based on the aforementioned research) and how these features would be accounted for under Topic 842 is presented below:

	Potential Current Practice under Subtopic 350-40	**Practice if an entity were to analogize to Topic 842**
Renewals	Costs to renew a software license are capitalized upon renewal and amortized over the remaining useful life of the software.	Costs for the term of the arrangement would be capitalized at contract commencement. The term of the arrangement would include the noncancelable period plus periods covered by renewals that are reasonably certain to be exercised, periods covered by termination options that are reasonably certain not to be exercised, and periods covered by renewals that are in the control of the vendor.
Variable Payments	Variable payments (and a related liability, if necessary) are accrued when they are determined to be probable.	Variable payments that depend on an index or a rate, if applicable to a CCA, would be included in the measurement of the software element based on the

		prevailing index or rate at the commencement date. Variable payments that do not depend on an index or rate would be accrued in periods before the achievement of the specified target that triggers the variable payment, provided the achievement of that target is considered probable.
Discount Rate	No guidance is included in Subtopic 350-40. However, entities may apply Subtopic 835-30 on imputation of interest.	The discount rate guidance in Topic 842 would not be relevant because it is based on an amount equal to the lease payments that would be borrowed on a collateralized basis.

24. Some of the guidance in Topic 842 for these features is consistent with current practice under Subtopic 350-40, but Topic 842 provides more explicit guidance. A significant difference relates to the capitalization of "reasonably certain" renewals under Topic 842. Outreach participants generally agreed that renewals of CCAs and term licenses should be capitalized and generally agreed that using the "reasonably certain" threshold in Topic 842 (which is a very high economic threshold), including the factors to consider in determining a reasonably certain renewal (for example, the incurrence of significant implementation costs), would be appropriate.

25. Current practice under Subtopic 350-40 and the guidance under Topic 842 for variable payments is not significantly different. Outreach participants generally did not have concerns with using the guidance in Topic 842 to account for variable payments. However, participants acknowledged that variable payments that depend on an index or rate are not common in CCAs. Rather, CCAs often include variable payments based on usage in excess of contractual minimums. Variable payments associated with increased usage of a CCA would not be capitalized using the guidance in Topic 842 or current practice under Subtopic 350-40, but, rather, would be expensed as incurred. One outreach participant indicated that the guidance for variable consideration in Topic 606 on revenue would be a better model for accounting for variable payments, but other outreach participants disagreed because that guidance would require the estimation of variable payments that are difficult to forecast (for example, usage-based fees), and for which feedback during the leases project led to not including those payments in the measurement of lease assets and liabilities.

26. For discount rates, outreach participants indicated that the guidance in Topic 842 would be difficult to apply because that guidance is based on an amount equal to the lease payments that would be borrowed on a collateralized basis. The nature of software makes it an intangible asset, and therefore different from a tangible asset (such as, a building) that can be used as

collateral. That difference would make it difficult to determine the amount of CCA payments made on a collateralized basis, if even possible. In any case, the staff was unable to determine how entities determine the discount rate for payments for software made over time under current practice.

27. Outreach participants generally preferred that specific paragraphs from Topic 842 be added to Subtopic 350-40 instead of referencing the guidance in Topic 842. This would reduce questions about whether an entity should or may analogize to other guidance in Topic 842 and simplify the guidance for CCAs.

Operating Lease Versus Finance Lease Analogies

28. The staff researched whether the capitalized software element of a hosting arrangement is more appropriately analogized to an operating lease or to a finance lease, considering the underlying economics of CCAs and the differences in financial statement presentation.

29. Under an analogy to an operating lease, a customer would recognize at contract commencement a liability measured at the present value of the unpaid hosting fees attributable to the software element, and would apply the "display approach" in Topic 842 for the initial measurement and subsequent amortization of the software asset. The customer would recognize a single CCA expense in profit or loss on a straight-line basis over the life of the arrangement, instead of recognizing amortization expense separate from interest expense. The amortization of the software asset therefore would be the difference between the straight-line amount recognized in profit or loss and the amount of interest accreted during the period for the liability (effectively, the amortization expense for the software asset would increase over time as the amount of the liability, and therefore interest, decreases). The customer also would present the payment for the hosting fees as an operating cash outflow. This would be consistent with how a lessee accounts for an operating lease under the new leases standard. This type of analogy would be based on the view that the customer is paying to use the software asset during the term of the arrangement rather than paying to finance the acquisition of the underlying software. This however would not result in a consistent accounting treatment between a CCA and an on-premise software license that is paid for over time because the latter is accounted for like a finance lease.

30. Under an analogy to a finance lease, a customer would recognize at contract commencement a liability measured at the present value of the unpaid hosting fees attributable to the software element (similar to the accounting above for an operating lease), but the customer would amortize the software asset on a straight-line basis over the life of the arrangement. The customer therefore would recognize in profit or loss amortization expense, and separately recognize interest expense on the CCA liability. The customer also would recognize the payment for the hosting fees representing the principal repayment of the liability as a financing

cash outflow and the interest on the liability generally as an operating cash outflow. This would be consistent with how a lessee accounts for a finance lease under Topic 842. This type of analogy would be based on the view that the customer is paying to finance the acquisition of the underlying software that will be used during the term of the arrangement. This would be consistent with how a customer accounts for the purchase of an on-premise software license that is paid for over time. The total periodic expense (that is, the sum of interest and amortization expense) under this type of analogy typically would be higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the liability, interest expense decreases as cash payments are made during the term of the arrangement and the CCA liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with the straight-line amortization of the software asset, results in a front-loaded expense recognition pattern.

31. Outreach participants had mixed views as to whether a CCA should be treated like an operating lease or like a finance lease. Three outreach participants (two preparers and one accounting firm) supported an analogy to a finance lease, one of which supported a finance lease analogy due to a fundamental disagreement with the display approach (that is, the approach used under operating lease treatment). Six participants (one preparer and five accounting/consulting firms) supported an operating lease analogy because they indicated that CCAs are more economically similar to operating leases because the customer does not own or "effectively own" the software at the end of the CCA term. One preparer indicated that entities should apply principles-based classification criteria, similar to those in Topic 842, to each CCA to determine whether to classify it as an operating lease or as a finance lease. That participant indicated that most CCAs typically would be classified as operating leases under those criteria.

Advisory Committees Feedback

32. The staff met with the Investor Advisory Committee (IAC), Small Business Advisory Committee (SBAC), and Private Company Council (PCC) to obtain feedback on this Issue and on the research that Task Force members asked the staff to perform.

Investor Advisory Committee (IAC) Feedback

33. Feedback from the IAC on the EITF's tentative conclusion to capitalize the software element of a CCA under Subtopic 350-40 was mixed. Some IAC members supported the decision to capitalize CCAs on the basis that there is no economic difference between a CCA and an on-premise software arrangement. Other IAC members did not support the EITF's tentative conclusion because they view a CCA as a subscription service and were concerned about capitalizing the software element in a CCA because a customer does not control the hosted

software. Some IAC members also expressed a view that applying a lease model to CCAs would not be appropriate because the vendor's ability to readily replicate the software indicated that the customer could not control the underlying software. However, one IAC member indicated that hosted software could be considered a lease if the customer is able to contractually control a defined amount of capacity to use the software. Most IAC members noted their preference for an expense approach because the economics of CCAs are more akin to a service.

34. IAC members generally agreed that if entities were to apply a lease model to CCAs, entities should treat CCAs like operating leases because CCA fees are ongoing operating expenses. IAC members indicated that operating lease treatment would provide the most decision useful information for these types of arrangements.

Small Business Advisory Committee Feedback

35. One SBAC member (a user) questioned the benefit of capitalizing the software element of a CCA. Another SBAC member (a user) emphasized the importance of consistency in determining the accounting for a CCA and a license of on-premise software, including expected renewals (whether entities expense or capitalize them). Several SBAC members stated that CCAs are similar to lease agreements and supported similar accounting. An SBAC member added that a CCA likely replaces certain internal costs related to software, hardware, and salaries of IT personnel, so that member supported the capitalization of the software element of a CCA, including implementation costs, to better depict the performance of the entity over time (rather than, for example, fully expensing the costs upfront and thereby reflecting a better performance in profit or loss in the subsequent periods).

Private Company Council Feedback

36. PCC members who expressed a view (mostly preparers and practitioners) disagreed with the Task Force's tentative conclusion to treat the software element of a hosting arrangement as an asset because they view a CCA as a service contract. Most PCC members supported capitalizing only the implementation costs of a CCA because they view the implementation costs of a CCA to be economically similar to implementation costs of on-premise software. The staff indicated that some implementation costs of a CCA would not meet the definition of an asset on their own based on an analysis of the Conceptual Framework. But some PCC members (preparers) expressed a view that the Conceptual Framework should not prohibit what they believe is a better accounting answer. When PCC members were asked about their views on the capitalization of expected renewals of CCAs, some PCC members (practitioners) opposed capitalizing renewal options because it would be too difficult to determine whether a renewal would be exercised due to the rapid change of technology.

Questions for the Task Force
1. Does the Task Force want to affirm its tentative conclusion to align the accounting for CCAs, wherein all CCAs would include a software element that would be within the scope of Subtopic 350-40 (Revised Alternative C)? If not, what alternative does the Task Force want to select? 2. If the Task Force chooses to affirm its tentative conclusion, which accounting alternative (Alternative 1 or Alternative 2) does the Task Force want to select to address the questions related to the capitalization of the software element of a CCA? 3. If the Task Force chooses to affirm its tentative conclusion, does the Task Force want to provide a practical expedient, similar to Topic 842, that allows an entity not to separate the hosting service from the associated software element? 4. If the Task Force chooses to affirm its tentative conclusion, does the Task Force want to provide guidance to account for a CCA like an operating lease or like a finance lease?

37. At the January 2018 EITF meeting, the staff plans to present the results of the research that was requested at the October 2017 EITF meeting so that Task Force members understand the recommended model for Revised Alternative C before deciding whether to affirm their tentative conclusion. The staff then plans to ask Task Force members the questions included above.

Alternatives for Accounting for Costs Incurred in a Software Cloud Computing Arrangement

38. Considering the additional staff research and outreach just described, the Task Force could decide to affirm its tentative conclusion of Revised Alternative C reached at its October 2017 meeting (as supplemented by one of the proposed alternatives in paragraph 41 based on the research the Task Force requested the staff to perform), or it could decide to revisit that decision. The following are the alternatives for the Task Force to consider:

> **Alternative B—Residual Approach Utilizing Guidance in Topic 606 to Determine What Is Distinct –** Implementation costs associated with a CCA that is considered a service contract would be recognized as an asset or an expense on the basis of existing GAAP (specifically, Topic 340, Subtopic 350-40, Topic 360, or Subtopic 720-45). Implementation costs that are not addressed by existing guidance would be expensed as incurred if the related activities are considered distinct from the hosting service (based on Topic 606) or capitalized as a prepaid asset for the services if the related activities are not distinct (based on Topic 606).

Original 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 – Implementation costs incurred in the preliminary project and post-implementation-operation stages would be expensed. Costs incurred during the application development phase (for example, costs for the CCA's integration with on-premise software, coding, and configuration or customization) would be capitalized. Those costs incurred for data conversion and training would be expensed as incurred.

Revised Alternative C—All Hosting Arrangements (as Defined in the Master Glossary) Are Within the Scope of Subtopic 350-40 – All CCAs would include a software element, which would be accounted for the same as internal-use software licenses, as supplemented by one of the proposed alternatives in paragraph 41.

39. Appendix A provides descriptions of these accounting alternatives that were included in Issue Summary No. 1, Supplements Nos. 1 and 2.

Alternatives for Addressing the Questions Related to the Capitalization of the Software Element of a CCA under Revised Alternative C

40. Based on the outreach performed, the staff developed alternatives to address the questions related to the capitalization of the software element of a CCA and measurement of the related liability (that is, questions related to the application of Revised Alternative C). The first alternative uses guidance from Topic 842 as a guide to answer the questions related to the recognition and measurement of the asset and liability in a CCA, while the second alternative relies on current practice (that is, there would be no change in guidance in Subtopic 350-40). While there could have been a third alternative (which would be to send entities to Topic 842 for the accounting for CCAs), the staff did not consider that alternative. On one hand, the staff notes that by bringing all CCAs into the scope of Subtopic 350-40, the number of transactions for which entities would need to evaluate certain features (for example, renewal periods or variable payments) would increase, and the guidance in Topic 842 might provide a sufficient framework to address those features. On the other hand, CCA transactions typically are less frequent and less complex than leases, and, therefore, sending entities to Topic 842 might result in unnecessary complexity and additional questions about whether (and if so, how) to apply some aspects of the guidance in Topic 842 to CCAs.

41. Accordingly, the Task Force could consider the following alternatives to supplement its prior tentative conclusion on Issue 1 (Revised Alternative C):

Alternative 1 – Include limited and specific guidance in Subtopic 350-40. Guidance on renewal/termination options and variable payments would be based on what exists in

Topic 842, and guidance on discount rates would be based on what exists in Topic 410 on asset retirement and environmental obligations.

Alternative 2 – Do not add any guidance. Entities account for renewal/termination options, variable payments, and discount rates today, so no additional guidance would be necessary.

Descriptions of Accounting Alternatives

Alternative 1 – Include limited and specific guidance in Subtopic 350-40.

42. Under Alternative 1, guidance for renewal/termination options and variable payments would be based on similar guidance in Topic 842. Guidance for determining the discount rate in the arrangement also would be provided based on guidance in Topic 410 (that is, an entity would use a credit-adjusted risk-free rate). The Task Force also could decide to provide a practical expedient in Subtopic 350-40 that allows an entity not to separate the hosting service from the associated software element, similar to the practical expedient in Topic 842 that allows a lessee not to separate the nonlease component from the associated lease component. This practical expedient would result in the capitalization of the entire CCA fee as an asset, but would resolve the practical challenges that could arise in separating the software element from the overall hosting fee.

Alternative 2 – Do not add any guidance

43. Alternative 2 would not add any guidance to Subtopic 350-40 on renewal/termination options, variable payments and discount rates. Current accounting practice would continue to be applied. This could result in diversity in practice. The staff's research and outreach did not indicate any significant diversity in practice today but that may be due to the limited number of transactions with these types of features. However, the Task Force could still decide to include a practical expedient in Subtopic 350-40 that allows an entity not to separate the hosting service from the associated software element, similar to Alternative 1, because the practical challenges associated with separating the software element from the overall hosting fee would still exist under the Task Force's current tentative decision on Issue 1 (Revised Alternative C).

Staff Analysis and Recommendation

Alternatives for Addressing the Questions Related to the Capitalization of the Software Element of a CCA under Revised Alternative C of Issue 1

Applying the leases guidance by analogy for renewals and variable payments

44. Alternative 1 uses the leases guidance as a guide to account for renewal/termination options, and that guidance would be included in Subtopic 350-40. This could change current practice to

require entities to capitalize fees for renewals that are reasonably certain to be exercised and fees for periods covered by termination options that are reasonably certain not to be exercised. As mentioned above, most entities do not capitalize renewals under Subtopic 350-40 until they are exercised under current practice. However, “reasonably certain” is a very high economic threshold and, therefore, only periods covered by a renewal option that meets this high threshold would be recognized on the balance sheet under Alternative 1.

45. While most companies amortize implementation costs over the noncancelable contract term, one outreach participant indicated that some entities amortize implementation costs over the expected economic life of the arrangement while only capitalizing the cost of the license for the noncancelable term of the arrangement. This creates a misalignment of amortization periods and also treats the implementation costs and the license as separate assets. If the leases guidance were used as a guide for the treatment of renewal/termination options, then the useful life of the implementation costs and the software would be aligned (and it would be the expected period of benefit as determined by the “reasonably certain” threshold).

46. Under Alternative 1, the guidance on variable payments in Topic 842 would be used to account for variable payments included in CCAs, but that guidance likely would not significantly change current practice. Variable payments in CCAs typically are usage-based fees or fees per user above a minimum. Both of these types of variable payments would be difficult to forecast, and Alternative 1 would not allow entities to forecast them. Estimating these fees also would add unnecessary complexity to the accounting for CCAs. Variable payments in Topic 842 are only capitalized if they are related to an index or rate, like the Consumer Price Index (CPI). Outreach indicated that few CCAs have variable payments related to an index or rate, so the addition of this guidance would not significantly change practice.

47. In summary, Alternative 1 leverages the guidance in Topic 842 to address the questions related to renewals and variable payments. Alternative 2 would not address these questions.

Discount Rate

48. The staff would add guidance to Subtopic 350-40 under Alternative 1 that would require entities to use the credit-adjusted risk-free rate as the discount rate to determine the present value of the CCA fees related to the software element. This guidance is similar to the guidance in Topic 410 and Topic 420 on exit or disposal cost obligations. The guidance on discount rates in these topics has been applied for some time and stakeholders have not raised concerns in applying it. The determination of the credit-adjusted risk-free rate would be based on the risk-free rate plus a risk premium, which is impacted by a company’s credit rating and market conditions. Using a different discount rate for calculating the liability in a CCA likely would not materially change the present value of the liability because of the limited term of most CCAs and the magnitude of the CCA fees, compared to lease arrangements (for which either individually or in

aggregate the discount rate may have a material impact). Most outreach participants indicated that the terms of CCAs, including renewals, would rarely extend beyond five to seven years. Providing guidance to determine the discount rate in a CCA would reduce complexity and diversity in practice. However, Alternative 2 would not add guidance on the determination of a discount rate and entities would likely continue current practice.

Analysis of Alternatives

49. Alternative 1 would include specific guidance in Subtopic 350-40 that would address the questions related to the capitalization of the software element of a CCA. Proponents note that this guidance could be tailored for CCAs, which would reduce complexity for preparers and reduce diversity because if no guidance was added to Subtopic 350-40, some preparers would analogize to Topic 842 while others may not. Proponents also note that this approach would limit some of the analogies to other guidance in Topic 842 because all of the guidance intended to be applied to CCAs would be included in Subtopic 350-40. Although the specific guidance may not address all situations, entities enter into CCAs less frequently than leases, and CCA transactions tend to be less complex than some lease transactions. Accordingly, a simplified approach would be more appropriate for these more limited CCA transactions, and outreach participants emphasized the need for an accounting solution that limits complexity. Opponents of this alternative note that the additional guidance may be too simple and may not anticipate additional questions that may arise as a result of capitalizing the software element of a CCA. They believe that a more complete analogy to Topic 842 would be more appropriate.

50. Alternative 2 would result in no additional guidance being added to Subtopic 350-40. Some proponents of Alternative 2 disagree with the capitalization of the fees related to renewal periods. They note that capitalization of renewals of contracts related to technology is not appropriate because of the rapid pace of change. Proponents of Alternative 2 also argue that there is not significant diversity in practice under Subtopic 350-40 and the questions identified by the staff are not new and are not specific to CCAs. Adding guidance to Subtopic 350-40 could unnecessarily change practice and could create additional complexity. Opponents of Alternative 2 believe that there is not significant diversity in practice today because there are few transactions with these types of features. Opponents of Alternative 2 also believe that if the software element of a CCA is recognized on the balance sheet, then additional aspects of the leases model (for example, the guidance for renewals/terminations, variable payments) should also be applied. The staff also notes that the rapid pace of technology changes would be factored into the negotiation of the noncancelable term of a CCA and through the determination of the accounting term of the CCA under Alternative 1 (which would include only periods that meet a very high economic threshold).

Staff recommendation on alternatives

51. If the Task Force chooses to affirm its tentative conclusion on Issue 1 (Revised Alternative C), the staff recommends Alternative 1 to address the questions related to the capitalization of the software element of a CCA because the additional guidance would be based on Topic 842 but it would be tailored to CCAs. Alternative 1 would only include specific guidance from Topic 842 that would be mostly relevant to CCAs, and would limit questions as to whether other guidance in Topic 842 should be applied. The staff believes that Alternative 1 creates a sufficient amount of guidance to reduce diversity in practice when the amendments become effective. The staff believes that there is a benefit to providing guidance on these questions in Subtopic 350-40. Although there is not significant diversity in practice today, the staff believes that these questions will become more prevalent as more CCA transactions fall within the scope of Subtopic 350-40 under the Task Force's tentative conclusion for Issue 1 (Revised Alternative C).

Practical Expedient Not to Separate the Hosting Service from the Associated Software Element

52. Under either alternative, the Task Force could provide a practical expedient that would allow a customer of a CCA not to separate the hosting service from the associated software element. This would be similar to the practical expedient provided to lessees in Topic 842. Paragraph 842-10-15-37 provides the practical expedient as follows:

> As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

Many outreach participants were concerned about the difficulty of separating the software element of a CCA from the hosting service. Outreach participants also indicated that the software element and hosting service are not clearly delineated in CCA contracts. Requiring entities to separate the contract into its elements would add unnecessary complexity and could result in the need for additional guidance. CCA contracts generally would comprise a very small portion of entities' balance sheets, and therefore the cost incurred by a company to separate the elements in a CCA may outweigh the benefit to users.

Staff recommendation

53. If the Task Force chooses to affirm its tentative conclusion on Issue 1 (Revised Alternative C), the staff recommends adding a practical expedient to allow entities not to separate the hosting service from the associated software element to reduce the cost and complexity of accounting for CCAs under the Task Force's tentative decision.

Operating Lease versus Finance Lease Treatment

54. The Task Force could require entities to treat CCAs like either operating leases or finance leases. Based on the feedback from the IAC, one of users' primary concerns about this project is the income statement classification of the CCA fees. Under operating lease treatment, there would be a single CCA expense that is recognized on a straight-line basis over the term of the CCA rather than separate presentation of amortization and interest expense in profit or loss. That single, straight-line, CCA expense would be included in another expense line item (for example, selling, general and administrative expense). Since the implementation costs would be added to the cost of the right-of-use asset, they would not be presented as amortization expense as well, which would be different than the treatment of implementation costs for on-premise software. Under operating lease treatment, the accretion of the liability would be included within the single straight-line CCA expense. The remaining portion of the straight-line CCA expense would represent the amortization of the software asset. In addition, the payments made to the vendor would be presented as an operating cash flow.

55. Under finance lease treatment, the presentation and recognition patterns of the expense would be different than under operating lease treatment. The software asset recognized in a CCA would be amortized on a straight-line basis over the term of the CCA and the liability would be accreted. These changes would be presented as amortization and interest expense, respectively. This presentation would increase an entity's EBITDA, which users often use to value an entity. Finance lease treatment also generally would increase cash flows from operating activities as compared to operating lease treatment. This is because, under finance lease treatment, the portion of the CCA payments that represents the repayment of principal on the liability would be presented as a financing cash flow rather than an operating cash flow under operating lease treatment.

56. Under either alternative, capitalized implementation costs paid by the customer would be categorized as cash flows from investing activities; implementation costs are often the most material amounts of a CCA and the cash flow presentation would be the same under either alternative.

57. Because the software element in a CCA is an intangible asset, judgment may be needed to determine whether the CCA would be an operating lease or a finance lease under the lease classification criteria in Topic 842, and there may be questions and added complexity about how to apply specific lease classification criteria to the software element similar to difficulties in practice that may have existed in applying paragraph 350-40-25-16 prior to being superseded by Update 2015-05 (for example, whether a customer can reliably estimate the fair value of the vendor's intellectual property in the present value test). Proponents of operating lease treatment argue that CCAs likely would not meet any of the criteria to be classified as a finance

lease, if the lease classification criteria were to be applied. They note that there is no transfer of ownership or purchase option included in these arrangements because the software remains with the vendor at the end of the CCA term. They view the customer as just using the software during the term of the CCA. On the other hand, proponents of finance lease treatment argue that the CCA term is for the major part of the remaining economic life of the software due to the rapid pace of change in technology. Therefore, they argue a CCA would meet that criterion to be classified as a finance lease.

Staff recommendation

58. If the Task Force chooses to affirm its tentative conclusion on Issue 1 (Revised Alternative C), the staff recommends that the Task Force require entities to treat all CCAs like operating leases because the staff believes that CCAs are more economically similar to operating leases in that the customer does not own or "effectively own" the software at the end of the CCA term. The staff also believes that the presentation of the CCA expense under operating lease treatment would provide more useful information to investors. The staff considered but decided not to propose that a customer in a CCA apply classification criteria similar to (or the same as) the lease classification criteria in Topic 842 to reduce costs and complexity of applying the potential guidance. Treating all CCAs as operating leases is consistent with the Task Force's tentative conclusion reached at its October 2017 meeting to align the accounting for all CCAs. While the operating lease treatment for CCAs would not be aligned with the accounting for on-premise software in that respect (on-premise software is accounted for like a finance lease because of the separate recognition of amortization and interest expense), the operating lease treatment would be more aligned with feedback received from various stakeholders following the October 2017 EITF meeting and would result in more decision-useful information for users.

Summary of Staff Recommendations for Additional Guidance in Subtopic 350-40

59. If the Task Force chooses to affirm its tentative conclusion on Issue 1 (Revised Alternative C), the following is a summary of the staff's recommendations to address the questions related to the capitalization of the software element of a CCA (whether the CCA includes a license or not):

a) The accounting term of a CCA would be determined considering options using a "reasonably certain" threshold of exercise (similar to Topic 842)

b) Variable payments generally would be excluded from inclusion in any liability until probable of payment, unless they depend on an index or rate (similar to Topic 842)

c) The rate used to discount the CCA payments would be a credit-adjusted risk-free rate (similar to Topic 410)

d) A practical expedient would be provided to allow an entity not to separate the hosting service from the associated software element (similar to Topic 842)

e) The CCA would be accounted for similar to an operating lease.

60. In summary, specific and limited guidance would be added to Subtopic 350-40 under the staff's recommendations.

Alternatives for Accounting for Implementation Costs Incurred in a CCA

61. Appendix A provides the staff's original analysis of Alternative B, Original Alternative C, and Revised Alternative C from Issue Summary No. 1, Supplement Nos. 1 and 2. The staff performed the following additional analysis based on feedback from the October 2017 EITF meeting and from the Advisory Committees.

Revised Alternative C

62. Revised Alternative C would result in the recognition of an asset that has similarities to a right-of-use asset under Topic 842. Proponents of Revised Alternative C believe that a CCA is providing a customer with the right to use software on a vendor's or third-party's system. A Board member at the October 2017 EITF meeting requested that the staff share information about whether a CCA would meet the definition of a lease under Topic 842. Paragraph 842-10-15-1 specifically excludes intangible assets from the scope of Topic 842. But without this scope exception, CCAs might meet the definition of a lease under some circumstances. The Board acknowledged in paragraph BC110(a) of the Background Information and Basis for Conclusions of Update 2016-02 that there was no conceptual basis to exclude leases of intangible assets from the scope of Topic 842. Appendix B discusses the characteristics of a CCA and whether under those characteristics CCAs would meet the definition of a lease.

63. While CCAs might not always meet the definition of a lease, proponents of Revised Alternative C believe that an asset is needed in order to capitalize the implementation costs in a CCA to remain consistent with the Conceptual Framework, and that it is appropriate to apply the leases model in Topic 842 as a proxy to CCAs by capitalizing the software element of a CCA. They note that the functionality of the underlying software, and the customer's use, is the same regardless of whether the software is delivered through the cloud or an on-premise software license. In other words, the customer has an economic resource irrespective of ownership or location of the software.

64. Opponents of Revised Alternative C believe that the software element in a CCA does not meet the definition of a lease in many cases. They argue that even if the software element of a CCA meets the definition of a lease, it would be inappropriate to apply the leases model to a CCA. Applying the leases model to a CCA without also considering whether the leases model should

be applied to other intangible assets could lead to unintended consequences or situations in which preparers try to apply the leases model to other intangible assets by analogy.

Original Alternative C

65. Original Alternative C requires the capitalization of implementation costs of a CCA that would be capitalizable under Subtopic 350-40. Certain members of each of the advisory committees that provided feedback were supportive of Original Alternative C. They noted that Original Alternative C would be a simpler approach to address the concern that was originally raised to the Board. These advisory committee members, as well as some outreach participants, also expressed the view that Revised Alternative C would be too complex to apply. The primary difference between Revised Alternative C and Original Alternative C is that Revised Alternative C would require the recognition of an asset and a liability for the software element of a CCA. The asset, excluding implementation costs, and the liability would be the same assuming no payments are made upfront. Proponents of Original Alternative C do not believe that a grossed-up balance sheet would provide decision useful information to financial statement users, particularly due to the frequency and magnitude of these transactions. This was confirmed by certain IAC members who preferred expensing the CCA fees. The staff notes that Original Alternative C would be inconsistent with most IAC members' preference that CCA fees be treated like an operating lease, instead of like a finance lease with amortization and interest expense, because they viewed the CCA fees as an ongoing operating expense. However, the preference by IAC members was specific to capitalizing CCA fees and not implementation costs.

66. Proponents of Original Alternative C understand the concern about capitalizing the implementation costs when they are not capitalized as part of a related asset. Although many proponents of Original Alternative C view the CCA as an executory contract, some proponents believe that there is a right-of-use asset in the arrangement, but it is hard to identify, initially measure, and subsequently measure. They note that Original Alternative C addresses the issue by not requiring the recognition of the underlying asset in the CCA while still allowing entities to capitalize the implementation costs to get that "asset" ready for its intended use. Proponents note that Original Alternative C provides a practical approach to accounting for these types of arrangements while still maintaining that there is an unrecognized asset in the arrangement similar to other unrecognized intangible assets. They believe that the benefits of recognizing a gross asset and liability on the balance sheet do not outweigh the costs and complexity of doing so.

67. Some have also expressed a view that Revised Alternative C could be changed to result in a similar outcome to Original Alternative C. They note that there is an asset underlying a CCA, but as a practical expedient, an entity should have the ability *not* to capitalize the related asset

and liability or essentially net them down. These proponents note that the staff recommended providing a practical expedient to not separate the hosting service from the software element and capitalize the entire CCA fee. But these proponents do not see a practical expedient that would allow an entity not to separate the software element from the hosting service and account for the entire CCA fee as a hosting expense to be that different from the practical expedient that the staff recommended. This would result in similar accounting to Original Alternative C. However, the staff notes that in many cases the software element of the CCA, rather than the hosting service, would be the most significant component of the CCA fee, based on the outreach performed. Therefore, the staff recommended the practical expedient as described in paragraph 53. In addition, opponents of Original Alternative C do not support the argument made about a practical expedient *not* to capitalize the related asset and liability or essentially net them down. They do not believe that it would be appropriate to have a practical expedient to expense the software element of a CCA while allowing for the capitalization of implementation costs for that asset. In their view, that type of practical expedient would be similar to a practical expedient that fixed assets below a threshold are expensed but the related installation costs are capitalized, which GAAP does not permit.

68. Opponents of Original Alternative C note that if there is a software element in a CCA, then that asset should be accounted for similar to on-premise software because similar economic transactions should be accounted for similarly. Opponents of Original Alternative C also note that if there is not an asset underlying a CCA, then on-premise software and CCAs are not economically similar and should not be accounted for similarly, including the related implementation costs. That is, although the implementation costs of both transactions themselves may be similar, since the underlying transactions are not, there is no conceptual basis on which to only account for the implementation costs similarly. Opponents also note that Alternative 1 for addressing the questions related to the capitalization of the software element of the CCA simplifies Revised Alternative C. They believe that the proposed model under Revised Alternative C would not be complex or cost prohibitive because of the limited number of CCA transactions.

Staff Recommendation

69. Based on the additional feedback, one staff member supports Revised Alternative C while other staff members support Original Alternative C. The staff member who supports Revised Alternative C believes that to be consistent with the conceptual framework, there needs to be an asset to which implementation costs can be added. Issue Summary No. 1, Supplement No. 1, provided the basis for the recognition of that asset in a CCA. In that staff member's view, the staff should recommend alternatives that are conceptually sound, and then evaluate the costs and complexity of applying a specific alternative in comparison to the benefits that it provides to

users. The staff could recommend relief as appropriate to reduce the cost and complexity to an appropriately low level (which are the objectives of Questions 2 through 4). While Revised Alternative C is more complex than Original Alternative C, the staff member who supports Revised Alternative C believes that only limited and specific guidance would be added to Subtopic 350-40 such that applying that alternative would not be significantly more complex than Original Alternative C, which already would require entities to determine whether implementation costs are capitalizable under Subtopic 350-40. The additional step of recognizing a liability and the corresponding increase in an asset under Revised Alternative C is not considered significant by that staff member. That staff member also notes that CCA transactions generally are not as frequent for a particular entity. Accordingly, that staff member believes that an appropriate balance between cost and complexity and benefits would be reached through Revised Alternative C. That staff member also believes that Revised Alternative C does not set a precedent for recognizing executory contracts on the balance sheet because a clear distinction would be made for CCAs (that is, in a CCA there is an asset while for executory contracts there isn't).

70. The staff members who support Original Alternative C believe that it is a more practical approach and response to the concern originally raised to the Board about the accounting for implementation costs. The staff members believe that an entity may incur significant costs to implement a CCA, which they believe may indicate a future benefit to the entity beyond the period over which the implementation services are performed because it makes the use of the software more valuable to the entity and that use is over a period longer than the implementation services (although this argument is not in line with the Conceptual Framework). That is, they believe the benefits of the implementation costs are not consumed as the implementation services are provided. They believe that Original Alternative C provides a practical accounting outcome without introducing the complexity of initially and subsequently accounting for the CCA contract on a gross basis. They also believe that Original Alternative C results in an asset for the implementation costs that is similar to a capitalized cost to fulfill a contract under Subtopic 340-40. Under that guidance, costs that relate to a specific contract and that are expected to be recovered are recognized as an asset if they generate or enhance resources of the entity that will be used in fulfilling the contract in the future. This guidance results in the capitalization of costs that are not capitalizable under other GAAP and that are not added to the measurement of another asset. They merely generate a resource for the entity. These staff members believe that the result of the implementation costs of a CCA generates a resource for the entity that is used in connection with the CCA.

Other Issues

71. Since Alternative B did not receive significant support from Task Force members at the prior EITF meetings, this Issue Summary Supplement will not discuss Issues 2 through 5 as if Alternative B was selected. If the Task Force does decide to support Alternative B, the Task Force may request that the staff perform an analysis of Issues 2 through 5 under Alternative B. For the purposes of simplicity, the rest of this memo is written under the assumption that the Task Force either affirms Revised Alternative C as a tentative consensus or reaches a tentative consensus on Original Alternative C.

Issue 2 – Amortization Period

72. Issue 2 was last discussed at the July 2017 EITF meeting for only Alternative B of Issue 1. Issue 2 is not relevant if the Task Force selects Revised Alternative C or Original Alternative C for Issue 1 because there is existing guidance in Subtopic 350-40 that an entity would apply when determining and reassessing the estimated useful life of the intangible asset recognized. If the Task Force selects Alternative 1 under Revised Alternative C, the guidance on the determination of useful life in Subtopic 350-40 would be amended to state that the useful life of the asset is the accounting term of the CCA. The staff believes that no further deliberations on this issue are necessary.

Issue 3 – Definition of Implementation Costs

73. The Task Force reached a tentative conclusion at the October 2017 EITF meeting to not provide a definition or description of implementation costs within Subtopic 350-40. While one Task Force member observed that adding a description of the different types of implementation costs could be helpful, the Task Force generally agreed that there was no need to include a definition or description of implementation costs because Subtopic 350-40 already has appropriate guidance that entities can apply. One Task Force member also noted that there is no significant diversity in practice today related to identifying implementation costs. The staff believes that no further deliberations on this issue are necessary.

Issue 4 – Scope of the Project

74. Some stakeholders questioned whether service arrangements that have a minor element of hosting (where the main provision of the arrangement is something other than providing hosting) would be in the scope of the amendments that result from this Issue. An example is a manufacturing contract that includes a small component of hosting for billing, logistics, and inventory management.

Stakeholder Feedback

75. At the October 2017 EITF meeting, one Task Force member noted that executory contracts that have a minor software element in the contract might be within the scope of Revised Alternative C, and, accordingly, Revised Alternative C might have unintended consequences related to executory contracts in general.

76. Other Task Force members expressed concerns with the definition of a hosting arrangement, which may be applicable under either Original Alternative C or Revised Alternative C. The definition of a hosting arrangement is as follows:

> 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.

77. The concern with the above definition is that the use of the phrase "licensing of software" in the first sentence may limit the number of arrangements to which this guidance would apply. The Task Force member noted that many CCAs do not include a license to the underlying software, so they would not be in the scope of the proposed guidance. At the October 2017 EITF meeting, Task Force members discussed amending the first sentence to address that concern.

Question for the Task Force
5. Does the Task Force want to provide any guidance on scope in addition to changing the definition of a Hosting Arrangement?

Staff Analysis and Recommendation

78. The staff appreciates that some Task Force members are concerned that the costs of executory contracts unrelated to a hosting arrangement could be capitalized under Revised Alternative C. The Task Force could include a predominance notion in Subtopic 350-40 to address that issue. There are other instances in the Codification that prescribe when an entity should apply specific accounting requirements. For example, there is guidance in Topic 606 to help entities determine whether they should apply the guidance on sales-based or usage-based royalties in paragraph 606-10-55-65. That guidance is applicable when the royalty relates only to a license of intellectual property or when a license of intellectual property is the *predominant* item to which the royalty relates. As another example, Topic 230, Statement of Cash Flows, provides guidance to determine whether cash flows that have characteristics of more than one category of classification—that is, operating, investing, or financing—should be bifurcated or, instead, classified based on the activity that is likely to be the *predominant* source or use of the cash flow item. However, that guidance was recently revisited in FASB Codification Update No.

2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, because significant diversity in practice existed about how to interpret and apply the predominance principle. That is, the lack of clear guidance about how to apply the predominance principle resulted in some entities applying the predominance principle narrowly (that is, to only a few cash receipts and cash payments), while other entities applied the principle more broadly.

79. The staff believes that inclusion of specific guidance about predominance, however, would not resolve all of the concerns about capitalizing costs related to executory contracts. In addition, a hosting arrangement may be significant to an arrangement even though it may not be the predominant element of the arrangement.

80. The staff believes that the concern raised about capitalizing costs related to executory contracts would be addressed in other ways. First, if an entity capitalizes the costs of an executory contract as an asset, it also would have to recognize a related liability. The staff believes that this result may limit the number of entities that try to capitalize other executory costs. Paragraph BC150 of Update 2016-02 addressed a similar concern for the practical expedient that allows a lessee not to separate the non-lease component from the lease component. It explains that the practical expedient would not be abused because of the corresponding liability that must be recognized when an asset is recognized. Second, the staff notes that paragraph 350-40-30-4 provides guidance about multiple elements included in the purchase price and requires entities to allocate the cost among all individual elements. The staff expects that the proposed practical expedient in Question 3 would allow an entity not to separate the hosting service from the associated software element. But the proposed practical expedient would not allow an entity not to separate other goods or services unrelated to the combined software element and hosting service. An entity would need to continue to separate those other goods and services and allocate the cost in accordance with paragraph 350-40-30-4.

81. Based on this analysis, the staff does not recommend providing additional guidance on scope. They believe that it is not necessary to include additional guidance on scope regardless of whether the Task Force affirms Revised Alternative C or reaches a consensus on Original Alternative C.

82. If the Task Force reaches a consensus, the staff also plans to ask stakeholders if they have any other concerns with the definition of a Hosting Arrangement in the proposed Update. Based on the feedback at the October 2017 EITF meeting, the staff would amend the definition of a hosting arrangement as follows in drafting the proposed Update:

> In connection with ~~the licensing of~~ <u>accessing and using</u> 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.

Issue 5 – Analogy to Other Service Contracts

83. In Issue Summary No. 1, the staff considered whether the EITF should allow, prohibit, or remain silent about whether the amendments that result from this Issue could be analogized to other transactions. The staff thinks that this can be a question for any FASB or EITF project, but because the topic was raised by stakeholders several times, as well as at the October 2017 EITF meeting, the staff would like to obtain additional feedback from the Task Force on this issue.

Stakeholder Feedback

Feedback on Revised Alternative C

84. At the October 2017 EITF meeting, some Task Force members expressed concerns with entities applying the amendments that would result from this Issue by analogy (that is, a leases model) to other arrangements involving the right to use intangible assets.

Feedback on Original Alternative C

85. Prior to the October 2017 EITF meeting, the staff performed outreach on the different accounting alternatives to account for implementation costs in a CCA. In this outreach, most participants did not have any concerns with companies applying the guidance by analogy to other types of service contracts, most preferred that the EITF remain silent. One participant observed that CCAs are so unique that it would be difficult to analogize the amendments resulting from this Issue to other service contracts. Another stakeholder indicated that they did not expect these amendments to have any unintentional and broad effect on other service contracts. That stakeholder explained that a CCA is different from other types of contracts in that a CCA generally is replacing an on-premise software license that was accounted for as an intangible asset. In contrast, entities enter into other service contracts typically to outsource a function that would have been accounted for as an expense prior to being outsourced. Finally, one accounting firm suggested that the Task Force should prohibit analogizing unless the Board takes on a project to account for implementation costs incurred in all executory contracts.

Question for the Task Force
6. Does the Task Force want to provide guidance about analogies to this Issue?

Staff Analysis and Recommendation

86. If the Task Force affirms its tentative decision on Revised Alternative C, the staff recommends that the Task Force remain silent on whether the amendments resulting from this Issue could be applied by analogy to other contracts that are not within the scope of this project, including contracts that provide the right to use intangible assets. The staff believes that the benefit of recognizing an asset for the right to use an intangible asset are offset by the requirement to recognize an associated liability. The primary benefit for a CCA is the ability to capitalize the implementation costs. The staff is not aware of contracts that provide the right to use intangible assets with significant implementation costs. Therefore, the staff does not believe that there likely would be an incentive to apply the amendments resulting from this Issue to other arrangements. However, if the Task Force decides to require entities to treat CCAs like finance leases, there could be an incentive to analogize to this guidance so that the payments for the right to use an intangible asset are presented as amortization expense.

87. If the Task Force reaches a consensus on Original Alternative C, some staff members recommend that the Task Force remain silent on analogizing because they do not want to set a precedent that guidance about analogizing be included in every project undertaken by the FASB or EITF. In addition, these staff members believe that a CCA is often different from other service contracts, as described above. These staff members believe that there are few service contracts that have implementation costs of the magnitude found in CCAs. Other staff members recommend that the Task Force prohibit analogizing because they believe that remaining silent could allow entities to capitalize costs incurred in preparation of other service contracts. To those staff members, it is unclear what specific characteristics one would consider to differentiate another service contract from a CCA in determining whether implementation costs can be capitalized, and the magnitude of the costs could not be the sole determinant in that evaluation. Because Original Alternative C has no natural offset like Revised Alternative C has (under Revised Alternative C there is a balancing act in that if one decides to analogize, a liability must be recognized), those staff members believe that analogies should be prohibited if Original Alternative C is selected.

Issue 6 – Disclosures

88. Prior to the October 2017 EITF meeting, the staff evaluated whether disclosures would be required with respect to this Issue. In doing so, the staff considered the existing GAAP disclosure requirements. Paragraph 235-10-50-3 states:

> Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to

appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods….

89. The staff also considered the disclosure requirements in Subtopic 350-40, but that subtopic does not require specific disclosures and, instead, refers entities to other existing authoritative literature for disclosures (such as Subtopic 360-10 on property, plant, and equipment).

Disclosures That May Apply If the Task Force Affirms Its Tentative Conclusion on Revised Alternative C

90. At the October 2017 EITF meeting, the Task Force requested that the staff perform research on whether any of the disclosures included in Topic 842 would be applicable to CCAs under Revised Alternative C. In researching the lease disclosures required for a lessee, the staff evaluated the disclosures and separated them into categories based on their relevance to CCAs. The disclosures and the staff's classification are listed below. For purposes of organization and clarity, each disclosure is numbered and will be referenced accordingly throughout the remainder of this Issue Summary Supplement.

Relevant		
	Paragraph	**Disclosure Requirements**
1	842-20-50-3(a)(1)	A general description of an entity's leases
2	842-20-50-3(a)(2)	The basis and terms and conditions on which variable lease payments are determined
3	842-20-50-3(a)(3)	The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right of use assets and lease liabilities and those that are not
4	842-20-50-3(c)(2)	Information about significant assumptions and judgments made in the allocation of the consideration in the contract between lease and nonlease components
5	842-20-50-3(c)(3)	Information about significant assumptions and judgments made in the determination of the discount rate for the lease
6	842-20-50-9	A lessee that elects the practical expedient on not separating lease components from nonlease components in paragraph 842-10-15-37 shall disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

7	842-20-50-4(a)	Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.
8	842-20-50-4(b)	Operating lease cost
9	842-20-50-4(d)	Variable lease cost

Could be Relevant		
	Paragraph	**Disclosure Requirements**
10	842-20-50-3(c)(1)	Information about significant assumptions and judgments made in the determination of whether a contract contains a lease
11	842-20-50-4(g)(1)	Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
12	842-20-50-4(g)(2)	Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
13	842-20-50-4(g)(3)	Weighted-average remaining lease term
14	842-20-50-4(g)(4)	Weighted-average discount rate
15	842-20-50-6	A lessee shall disclose a maturity analysis of its finance lease liabilities and operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

Not Relevant		
	Paragraph	**Disclosure Requirements**
16	842-20-50-3(a)(4)	The existence and terms and conditions of residual value guarantees provided by the lessee
17	842-20-50-3(a)(5)	The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.
18	842-20-50-3(b)	Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the

		construction or design of the underlying asset.
19	842-20-50-4(c)	Short term lease cost, excluding expenses relating to leases with a lease term of one month or less
20	842-20-50-4(e)	Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense
21	842-20-50-4(f)	Net gain or loss recognized from sale and leaseback transactions
22	842-20-50-7	Lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.
23	842-20-50-8	A lessee that accounts for short-term leases in accordance with paragraph 842-20-25-2 shall disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments.

91. The staff performed outreach with stakeholders as described in paragraph 16 above. Outreach participants did not support requiring all of the Topic 842 disclosures, particularly some of the disclosures the staff classified as "Could be Relevant," because CCAs are less frequent than lease transactions and many disclosures in Topic 842 would not provide decision useful information to users about CCAs.

92. Disclosures 1 through 9 could be applied to CCAs without significant amendments or judgement by the preparer. Note that either Disclosure 7 or Disclosure 8 would be required depending on whether the Task Force decides to require either operating lease treatment or finance lease treatment. Disclosures 10 through 15 have the potential to be applied to CCAs, but they would not be directly applicable or could be costly to apply. For example, Disclosure 10 would need to be amended to require an entity to disclose the assumptions or judgments made in determining whether a contract contains a hosting arrangement. Disclosures 11 through 15 could require significant cost and effort to provide, and the benefits to a user of providing them may not outweigh the costs. The remaining disclosures (Disclosures 16 through 23) are specific to leases and would not be applicable to CCAs.

Questions for the Task Force
7. Does the Task Force want to require additional disclosures for CCAs within the scope of this Issue? 8. If the Task Force affirms its tentative conclusion on Revised Alternative C and wants to require additional disclosures for CCAs, does the Task Force agree with the staff's analysis as to which disclosures from Topic 842 should be provided?

Staff Analysis and Recommendation

93. The Disclosure Framework Project, currently in progress, provides guidance on disclosure requirements. Two primary criteria that must be considered are whether the disclosure would be relevant to a user, and whether there is a reasonable cost/benefit relationship as a result of providing a disclosure.

If the Task Force Affirms Its Tentative Conclusion on Revised Alternative C

94. Application of the amendments resulting from this Issue would involve judgment and certain assumptions (for example, allocating costs to the software and hosting elements of a CCA, or determining the useful life of assets recognized). The staff recommends requiring Disclosures 1 through 6 from the lease disclosure chart above. The staff believes that these disclosures, if material, would provide useful information about the recognized asset and liability. The recommended disclosures would provide users with an understanding of how the amounts presented on the balance sheet for the software asset and liability are determined, whether there is uncertainty in that carrying amount, and how that carrying amount would change if alternative inputs were used.[1] The staff believes that the benefits of providing these disclosures would exceed the costs of providing them.

95. The staff believes that the remaining disclosures would not enhance the user's understanding of the CCAs because CCA transactions are less frequent than lease transactions and generally have terms that are similar (compared to leases, which can be short term or long term in nature), and, therefore, the costs of providing the disclosures would exceed the benefits of providing them.

[1] Disclosure recommendation based on proposed Concepts Statement, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, Appendix A, Question L14

If the Task Force Reaches a Consensus on Original Alternative C

96. The staff generally believes that no additional disclosures would be required. However, one stakeholder noted that the Task Force could be explicit and state that CCAs represent a major class of assets, which would require disclosures separate from other major asset classes.

Issue 7 – Transition

97. For this Issue, the Task Force could require retrospective transition, require prospective transition, or allow entities to choose between retrospective or prospective transition.

Question for the Task Force
9. Does the Task Force want to require retrospective transition, require modified retrospective transition, require prospective transition, or allow entities to choose between some of the alternatives?

Staff Analysis and Recommendation

98. In Update 2015-05, the Board concluded that an entity can elect to adopt the amendments either (a) prospectively to all arrangements entered into or materially modified after the effective date of Update 2015-05 or (b) retrospectively.

99. Under a retrospective transition, an entity would be required to restate all CCAs within the scope of this Issue through a cumulative-effect adjustment to retained earnings for CCAs entered into prior to the beginning of the earliest period presented in the financial statements, or through earnings for CCAs entered into after the beginning of the earliest period presented. This approach would enhance comparability, but increase costs to an entity due to having to restate the accounting for CCAs within the scope of this Issue in the comparative period or periods.

100. Under a typical modified retrospective transition, an entity would be required to restate all CCAs within the scope of this Issue through a cumulative-effect adjustment to retained earnings for CCAs entered into prior to the effective date. This approach would enhance comparability, but not to the extent of retrospective transition, and increase costs to an entity compared to prospective transition due to the entity having to restate the accounting for CCAs within the scope of this Issue at the effective date.

101. Under a prospective transition, an entity would apply the guidance to CCAs within the scope of this Issue that are entered into, renewed, or materially modified (consistent with Update 2015-05) on or after the effective date of the amendments resulting from this Issue. This would be the least costly method, but it would produce less comparative information across periods.

102. Allowing entities to choose the transition method would reduce comparability among entities, but there would be transition disclosures that would help users understand how an entity adopts the amendments resulting from this Issue and how it affects the financial statements of that entity.

103. While it generally is preferable for all entities to apply the amendments in any Update in the same way, the staff acknowledges that over the next few years, entities will have to adopt major new accounting guidance (such as Topic 606, Topic 842, and Topic 326 on credit losses). Entities may appreciate the flexibility of choosing between retrospective and prospective transition, and will decide based on what makes the most sense for that entity and its users (based on the costs and benefits of transition to that specific entity and its users). An entity also would be required to provide transition disclosures to help users understand how the amendments resulting from this Issue affected the entity's financial statements.

104. Accordingly, the staff recommends that the Task Force permit an entity to choose between prospective and retrospective transition. Such a transition approach would be consistent with the transition requirements for the amendments in Update 2015-05. Due to the significance and frequency of CCA transactions, the staff believes that the choice between prospective and retrospective transition would allow entities with significant CCAs and implementation costs to adopt it retrospectively, while those entities that don't have significant CCAs and implementation costs would be allowed to adopt it prospectively, which would provide useful information to their respective investors while limiting the costs of implementation.

Issue 8 – Transition Disclosures

105. The guidance on other presentation matters in Subtopic 250-10, Accounting Changes and Error Corrections—Overall, is applicable for a change in accounting principle. Paragraphs 250-10-50-1 through 50-3 require an entity to disclose the nature of and reasons for the accounting change, the transition method the entity applied, the quantitative effect of the change on the entity's financial statements, and any indirect effects of the accounting change, among other things.

Question for the Task Force
10. What transition disclosures does the Task Force want entities to provide when initially applying the amendments that result from this Issue?

Staff Analysis and Recommendation

106. If an entity elects prospective transition, that entity would be required to account for any of its CCAs that are within the scope of this Issue under two approaches in the year of adoption to comply with all disclosure requirements for prospective transition in accordance with Topic 250.

The Task Force could instead require an entity that applies the amendments resulting from this Issue on a prospective basis to 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 staff thinks it would not be cost-beneficial to require quantitative disclosures that would effectively require an entity to maintain two sets of accounting solely in order to meet disclosure requirements that would not be required for the production of the entity's basic financial statements.

107. If an entity elects retrospective transition, then the entity should disclose the requirements for prospective transition described above (that is, 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) and quantitative information about the effects of the change on specified reported items. An entity that adopts the amendments resulting from this Issue retrospectively should provide quantitative disclosures to allow users to understand the changes to the restated financial statements with information previously issued. An entity that elects the retrospective transition will have the information necessary for these disclosures as a result of producing its financial statements, and therefore the incremental cost of providing these disclosures should not be significant.

108. Accordingly, the staff recommends that the Task Force provide the following transition disclosure requirements:

    a) 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.

    b) 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.