EITF Issue 17-A, Issue Summary No. 1, Supplement No. 3

Appendix A

1. The purpose of this appendix is to provide Task Force members with a description and analysis of Alternative B, Original Alternative C, and Revised Alternative C. The content in this appendix is compiled from Issue Summary No. 1, Supplements Nos. 1 and 2. The Task Force may consider this appendix in determining whether to affirm Revised Alternative C as a tentative consensus or reaching a tentative consensus on a different alternative for the Issue.

Alternative B – Residual Approach Utilizing Guidance in Topic 606 to Determine What Is Distinct

2. Alternative B fundamentally is a residual approach in that an entity would apply existing GAAP guidance (for example, Topic 340, Other Assets and Deferred Costs, Subtopic 350-40, Topic 360, Property, Plant and Equipment, or Subtopic 720-45, Other Expenses—Business and Technology Reengineering) to the arrangement to determine whether costs related to specific implementation activities should be recognized as an asset or, instead, expensed as incurred. One aspect of this residual approach, if the costs are not already addressed by other GAAP guidance, would be to determine whether the activities related to those costs are distinct from the hosting service using the guidance in Topic 606. Costs for these residual implementation activities should be expensed as incurred if considered distinct from the hosting service or recorded as a prepaid asset if considered not distinct.

3. Some of the guidance upon which Alternative B is based (that is, Topic 340, Subtopic 350-40, Topic 360, and Subtopic 720-45) has been applied in practice for an extended period and, therefore, many stakeholders already are familiar with such guidance. But some of the guidance also would be new, such as the application of the distinct guidance in Topic 606.

4. The following table sets forth the scope of the accounting guidance for typical costs or activities in a CCA under Alternative B:

Guidance	**Example Costs or Activities within Applicable Guidance**
Subtopic 350-40	Software licenses acquired for set-up and implementation of CCA Coding and configuration of customer's on-premise systems
Topic 360	Hardware acquired for the set-up and implementation of CCA (for example, laptops, tablets, servers, and other equipment)

Topic 340	Assets for prepayments of services not yet performed (for example, a prepaid asset for a service to be performed by a consulting firm over a six-month period that the customer pays at inception of the contract)
Subtopic 720-45	Business process reengineering activities
Topic 606	Residual activities, such as customization and configuration of the hosted software, training employees to effectively use the cloud solution, data migration, or conversion activities; unless those activities are addressed in other GAAP guidance. If the activities are considered distinct based on the application of Topic 606, costs for those activities would be expensed as incurred.

5. Alternative B would be consistent with the amendments described in Update 2015-05 because, as described in paragraph BC6 of that Update, the amendments were intended to align the customer's evaluation of whether it is obtaining a software license or a service in a CCA with the evaluation that the provider undertakes.

6. Proponents of Alternative B also note that the amendments in Update 2015-05:

   a) Were conceptually sound – The amendments effectively distinguish between a contract for a software license (that is, one in which the customer obtains an asset) and one for services. When the criteria in paragraph 350-40-15-4A are met, the cloud service provider has transferred an asset to the customer and the customer controls an asset from which it can derive economic benefits independent of the cloud service provider's performance. CCAs that do not meet those criteria are similar to other service contracts that require continued and active performance by the vendor and do not transfer an asset to the customer at service commencement.

   b) Promoted consistency between vendors and customers in determining whether an asset is acquired – The amendments were derived from guidance that already existed for vendors.

7. Opponents of Alternative B argue that costs for configuration activities to implement a CCA that is considered a service contract generally would be expensed as incurred. Based on feedback received from stakeholders, costs for configuration activities can be one of the largest implementation costs. These opponents explain that these configuration costs are costs to get the CCA ready for its intended use, and therefore should be capitalized rather than expensed as incurred.

8. Some opponents of Alternative B also note that if the CCA cannot function as intended without the other services, then the activity is not distinct, regardless of who performs the work. Therefore, they do not agree that cost for configuration activities should be expensed as incurred because they view those activities as integral to the use of the hosted software.

Consistency in Accounting Outcomes Irrespective of Who Performs the Work

9. At its July 2017 EITF meeting, some Task Force members expressed reservations with Alternative B, which they perceived as potentially resulting in a different accounting outcome for identical costs depending on who performs the service. However, the staff believes that the application of Alternative B would result in consistent accounting outcomes. Accordingly, the staff would like to clarify the application of the distinct guidance in Topic 606 to certain costs for implementation activities that are not already addressed by existing GAAP guidance. Those costs would include, for example, customization and configuration of the vendor's software. It is presumed, in this analysis, that such activities transfer a good or service to the customer. That is, those activities are not simply administrative tasks to set up the contract; they provide incremental benefits to the customer beyond merely accessing the hosted software. In addition, customization activities included in this discussion are those applied to the vendor's software only. If customization services were performed on the customer's on-premise software, those activities would be within the scope of Subtopic 350-40.

10. Paragraphs 606-10-25-19 through 25-22 (along with the implementation guidance and illustrations) provide the guidance for determining whether a promised good or service is distinct. The two criteria that must be met for a good or service to be distinct is that the good or service is capable of being distinct (the primary guidance being in paragraphs 606-10-25-19(a) and 606-10-25-20), and that the good or service is separately identifiable in the context of the contract (the primary guidance being in paragraphs 606-10-25-19(b) and 606-10-25-21).

11. In general, customization activities will not be considered a distinct good or service under Topic 606. This could be because the customization services are not capable of being distinct (for example, if the cloud service provider does not regularly sell customization services separately and the solution does not function without the customization services). This also could be because the customization services are not separately identifiable in the context of the contract. Specifically, the customization services generally significantly modify and/or customize the software, and the software together with the customization services are inputs to the combined output for which the customer has contracted. Accordingly, the software and related customization activities typically will comprise a single performance obligation from a vendor perspective. Note that for this analysis the staff excluded situations in which customization of the vendor's software is performed by a consultant unrelated to the vendor because, based on

feedback obtained during outreach, cloud service providers generally do not permit third parties to customize (that is, change the coding of) the vendor's software for proprietary reasons.

12. Other implementation activities, such as configuration activities, training, or data conversion, typically would be considered separate performance obligations from a vendor perspective, irrespective of who performs the activity. These activities generally will be capable of being distinct, and will be separately identifiable in the context of the contract because those activities generally will not modify or customize the cloud service provider's software, and, consequently, also will not be inputs to a combined output. While there could be situations in which activities, such as configuration activities, may not be considered separately identifiable in the context of the contract (for example, because of specialized configuration activities that only the cloud service provider can perform, the vendor cannot fulfill its promise to transfer access to the hosted software separately from its promise to perform the configuration services), the staff generally believes that this would be the exception rather than the rule in the context of CCAs. Accordingly, services provided for activities other than customization activities will be distinct services to the extent that an entity other than the cloud service provider could provide those professional services, which generally will be the case for CCAs.

13. However, considering the perceptions around Alternative B and subsequent feedback obtained, the Task Force could simplify the application of Alternative B by including explicit guidance to determine whether implementation activities are considered distinct, rather than referring entities to Topic 606. Accordingly, the staff considered including the following explicit guidance within Alternative B that would be used to determine whether an activity is distinct from the cloud service provider's hosted software. This proposed guidance would apply to those residual activities not addressed by other GAAP guidance, and would result in a conclusion that generally is consistent with that which would be reached if an entity applied the guidance in Topic 606. This guidance would be based on the following questions:

    a) Does the implementation activity transfer a good or service to the customer? If no, the activity is a setup or administrative activity and the costs for those activities may be considered a prepaid asset. If yes, go to the next question.

    b) Is the implementation activity that is being performed or provided significantly customizing the hosted software? If yes, the activity is not distinct from the hosted software and the costs for those activities may be considered a prepaid asset. If no, go to the next question.

    c) Could the implementation activity be provided by someone other than the vendor (that is, a third-party consultant or internally), ignoring contract restrictions, or is it sold separately by the vendor (that is, the customer could choose to purchase it)? If yes, then regardless of who performs the work, the activity would be considered distinct and therefore the costs for those activities would be expensed as incurred. If no, then the activity is not distinct from the hosted software and the costs for those activities may be considered a prepaid asset.

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*

14. Under Original Alternative C, an entity would account for implementation costs incurred in a CCA in a manner consistent with implementation costs when a software license is acquired under Subtopic 350-40. However, the hosting fees would still be expensed as incurred considering the executory nature of the CCA.

15. Under Original Alternative C, an entity would expense those costs that are incurred in the preliminary project and post-implementation-operation stages. Costs incurred for setup fees should be accounted for in accordance with guidance on prepaid assets in Topic 340, or other relevant guidance. Costs incurred for integration with on-premise software, coding, and configuration or customization are capitalized as intangible assets. Those costs incurred for data conversion and training are expensed as incurred. Any costs for business process reengineering would be accounted for in accordance with Subtopic 720-45.

16. For upgrades and enhancements, costs incurred would be capitalized if they resulted in additional functionality. Internal costs for upgrades and enhancements would be capitalized or expensed in accordance with the guidance on application development costs in paragraphs 350-40-25-2 through 350-40-25-6. Any maintenance costs should be expensed as incurred.

17. Proponents of Original Alternative C assert that the implementation costs for CCAs that are service contracts are economically similar to those incurred in an on-premise solution and, therefore, the accounting for implementation costs should be consistent. Proponents of Original Alternative C also explained that preparers do not have a difficult time using the guidance in Subtopic 350-40 for implementation costs for a software license. Therefore, they do not think it makes sense to create a new model, such as that under Alternative B, which may be more difficult for preparers to implement. These stakeholders preferred to treat the implementation costs the same even though that may result in capitalizing implementation costs related to an overall arrangement that is not an intangible asset.

18. Proponents of Original Alternative C supported extending the guidance that requires capitalization of direct and incremental costs necessary to get the software ready for the entity's intended use for CCAs that are accounted for as service contracts.

19. Opponents of Original Alternative C highlighted conceptual concerns with allowing for capitalization of costs in situations in which the entity does not have control of an asset. Based

on the Board decisions resulting in Update 2015-05, those arrangements that do not meet both criteria in paragraph 350-40-15-4A are accounted for as service contracts and do not constitute a purchase of, or convey a license to, software. In other words, the FASB decided that the underlying arrangements (license or service contract) were not to be accounted for in the same manner. They were concerned the costs could be treated in the same manner because the underlying arrangement in a service contract is not an asset. Opponents also were concerned that Original Alternative C essentially unwinds the conceptual basis of Update 2015-05 and some stakeholders may eventually assert that the criteria and model introduced therein would need to be reevaluated to possibly allow for capitalization of the overall CCA as an intangible asset. Opponents of Original Alternative C also note that this model would be a significant change in practice for many preparers who currently have CCAs that are service contracts, and who have sought to apply the other GAAP guidance described in Alternative B.

20. Opponents of the Original Alternative C also have concerns with the conceptual merits of that alternative because the conceptual construct of Original Alternative C, if Update 2015-05 remains in place, is about capitalization of services in preparation for other services. However, there are few (if any) similar circumstances in existing GAAP. Initial direct costs of an operating lease are capitalized under Topic 840, Leases, and Topic 840 does not require lessees to recognize operating leases on the balance sheet. However, Topic 842 will supersede Topic 840 and will require that lessees recognize all leases on the balance sheet, other than short-term leases. While some proponents of Original Alternative C cite leasehold improvements as another example, Topic 842 again will require lessees to recognize most leases on the balance sheet.

21. While the accounting for implementation costs would be consistent between CCAs that include a software license and CCAs that are considered service contracts, opponents of the original Alternative C also note that the accounting for the hosting fees would not be consistent. Specifically, in a CCA that includes a software license, the hosting fees attributable to the software license must be capitalized as an intangible asset with a corresponding liability to the extent the fees are paid over time (with an element of time value of money). In contrast, if a CCA does not include a software license, the hosting fees are expensed as incurred. This inconsistency in accounting in turn would result in differences in presentation on the income statement, in classification on the statement of cash flows, and in presentation and outcomes on entities' performance metrics, such as EBITDA (although a non-GAAP metric).

22. The GAAP differences related to the hosting fees between CCAs that include a software license and CCAs that are considered service contracts are illustrated in the table below. These differences would not be in line with proponents of Alternative C's view that CCAs that are service contracts are economically similar to software licenses.

Financial Statement	CCA Includes a Software License	CCA Is Considered a Service Contract
Balance Sheet	Intangible asset Liability (unless fully paid at initial asset recognition)	N/A, or prepaid asset (accrued expense) depending on timing of payments in relation to the service
Income Statement	Amortization expense for the intangible asset Interest accretion on the liability	Operating expense
Statement of Cash Flows	Investing outflows (for prepayments) Financing outflows (principal) and generally operating outflows (interest)	Operating outflows

23. Some opponents of Alternative C also note that the decisions made in Update 2015-05 were based on guidance that already existed from a vendor perspective (that is, Subtopic 985-605 on revenue recognition for software). Alternative C might question the validity of the decisions made in Subtopic 985-605 and potentially of those made in Topic 606 (which retained that same guidance for determining whether a vendor is selling a software license or a service).

Revised Alternative C—*All Hosting Arrangements (as Defined in the Master Glossary) Are Within the Scope of Subtopic 350-40*

24. Revised Alternative C would expand the amendments made in Update 2015-05 such that all CCAs would include a software element and be within the scope of Subtopic 350-40 on internal-use software (not just those CCAs that include a software license based on paragraph 350-40-15-4A) under the premise that all CCAs provide an economic resource to the customer, irrespective of ownership or location of the software. This important change was primarily driven by the additional feedback received both at the EITF meeting and subsequently through discussions with stakeholders. But the change also was influenced by the additional research that the staff performed in evaluating whether there would be other ways to determine whether costs for implementation activities result in the creation of an asset for the customer when the premise for such analysis is that the CCA is a service contract.

25. Revised Alternative C makes the accounting for the implementation costs conceptually consistent with the underlying hosting arrangement. In Subtopic 350-40, costs associated with implementation activities are not capitalized as a separate or stand-alone asset. Instead, the software is the identified asset and costs of implementation activities are added to the

measurement of the software asset if they are incurred to get the asset ready for its intended use. Revised Alternative C identifies a software element (and the right-to-use that software) in all CCAs, which is the asset to which implementation costs can be added.

26. Many if not most CCAs are being accounted for as service contracts based on the amendments in Update 2015-05 (which was the expectation at the time the Update was issued). However, proponents for capitalization note that the functionality obtained in a CCA is often indistinguishable from that obtained in an on-premise software solution, so a software element should be accounted for in all CCAs. They note that the customer's ability to take possession of the software should not be the key determinant because 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. In addition, the staff observes that accounting standards, particularly in recent years, have moved away from a binary conception of control (for example, from FASB Statement No. 66, *Accounting for Sales of Real Estate*, to Topic 606 where legal title now only is an indicator of control).

27. The staff believes that if a version of Alternative C continues to be proposed, such an alternative should in effect converge the accounting for CCAs that are considered service contracts with the accounting for CCAs that include a software license. Said differently, the staff believes that there should be a similar accounting outcome for the implementation costs of a CCA and for the hosting fees. This would be consistent with feedback that said that CCAs that are considered service contracts are economically similar to software licenses.

28. Revised Alternative C would expand the scope of Update 2015-05 to all CCAs, but it would do so based on additional information obtained since the issuance of that Update. The Master Glossary definition of *hosting arrangement* added by Update 2015-05 would be retained and would be used in Revised Alternative C to determine those transactions that are within the scope of Subtopic 350-40.

29. Revised Alternative C would be detached from the vendor's perspective, but this would be done consistent with feedback that said that an alignment between customers and vendors is not required.

30. The staff acknowledges that additional effort may be required to separate the software element from the hosting service and allocate the hosting fee to each element under Revised Alternative C. However, the Task Force could address that issue by allowing an entity not to separate the hosting service from the software element, similar to the practical expedient provided in paragraph 842-10-15-37 that allows a lessee not to separate nonlease components from the lease components to which they relate, and instead account for each separate lease component and the associated nonlease components as a single lease component.

31. Opponents of Revised Alternative C are concerned that it would require an entity to recognize service contracts on the balance sheet. They note that this would be inconsistent with the Conceptual Framework, in part because the customer does not control the service. The customer expects to receive the service and it might have some legal recourse if it does not receive the service, but it does not control the service. The service does not exist before it is performed. Opponents also note that Revised Alternative C would be inconsistent with the accounting for most other service contracts. While it is fair to say that in a CCA, the customer has contracted for hosting for a period of time at a specified price, the same could be said of many other arrangements that are not recognized on the balance sheet (for example, cleaning and maintenance or consulting).

32. Opponents of Revised Alternative C also are concerned with the additional effort that it would require. They note that customers would be required to separate the software element from the hosting service and allocate the hosting fee to each element. This separation would be subject to significant judgment because there may not be objective evidence of the fair value of the software element when the CCA vendor does not separately sell a license to the underlying software element or when the functionality of the software element and the hosting service are interdependent. Opponents also note that Revised Alternative C requires additional effort related to the requirement to capitalize the software element of a CCA.

Practical Questions Related to the Capitalization of the Software Element of a CCA

33. The staff is aware of practical questions related to the application of the requirement to capitalize the software element of a CCA. Some of these questions include the following:

    a) How should a customer consider renewal/termination options in the initial measurement of the asset and the liability?

    b) What discount rate should be used to measure the present value of the hosting fee attributable to the software element?

    c) How should variable payments be considered when measuring the asset and the liability?

34. Issue Summary Supplement No. 3 provides a description of the staff's proposed model for approaching the practical questions outlined above.