

Memo No. 1

MEMO

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Project	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	Pre-Agenda Research		
Issue(s)	Cloud Computing		

Purpose of This Memo

1. The purpose of this memorandum is to obtain the PCC's feedback on the Board's pre-agenda research project on a customer's accounting for implementation costs incurred in a cloud computing arrangement that does not include a software license and is, therefore, considered a service contract. More specifically, the memorandum asks for feedback on:
 - (a) Whether the accounting for implementation costs incurred in a cloud computing arrangement is a prevalent concern to private company stakeholders
 - (b) Whether such implementation costs are significant for private companies
 - (c) The advantages and disadvantages of the alternatives previously presented by the staff to the Board, or ideas for other alternatives
 - (d) Benefits and costs of addressing the issue.

Background Information

2. In April 2015, the FASB issued Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40)*. Update 2015-05 provides guidance about a customer's accounting for fees paid in a cloud computing arrangement (also known as a hosting arrangement).

3. The guidance to be applied by a customer in a cloud computing arrangement includes criteria to distinguish between arrangements that provide a customer with control of a software license and arrangements that do not provide a customer with control of a software license. Those criteria to be applied by a customer are the exact same criteria that have long been applied by a cloud computing vendor to determine when an arrangement includes the sale or license of software for purposes of revenue recognition.
4. If a cloud computing arrangement includes a license to internal-use software, then the software license is accounted for by the customer in accordance with Subtopic 350-40. This generally means that an asset is recognized for the software license and amortized over its useful life. If a cloud computing arrangement does not include a license to internal-use software, the entity would account for the arrangement as a service contract. In practice, service contracts generally are expensed as incurred.
5. Some stakeholders have stated that GAAP is unclear about the accounting for implementation costs for a cloud computing arrangement for which there is not a software license. Implementation costs include setup and other upfront fees to get the arrangement ready for use. Other implementation costs can include training, creating or installing an interface, reconfiguring existing systems, and reformatting data.

Issue: Accounting for implementation costs incurred in a cloud computing arrangement

6. Since Update 2015-05 was issued, several stakeholders contacted the FASB staff requesting that the Board provide additional guidance on accounting for implementation costs associated with cloud computing arrangements that are considered service contracts. They told the staff that there is currently diversity in practice. Additionally, some stakeholders think that capitalizing certain of those costs would more faithfully represent the economics of the transaction. Also, some stakeholders do not think the accounting for implementation costs should vary depending on whether the implementation costs are for an arrangement that includes a software license that the customer controls or an arrangement that does not include a license that the customer controls. GAAP already includes guidance for implementation costs for software arrangements that include a license. Under that guidance, some costs are expensed and some are capitalized.

7. Most stakeholders said that companies analogize to different areas within the Codification to account for implementation costs incurred with cloud computing arrangements that are considered service contracts, including the following:
 - (a) Expense all or most implementation costs associated with cloud computing arrangements that are considered service contracts
 - (b) Analogize to Subtopic 350-40 on internal-use software for implementation costs incurred to integrate (bridge) the cloud computing arrangement with the existing on-premise software
 - (c) Analogize to Topic 340 on other assets and deferred costs for certain upfront fees
 - (d) Analogize to the revenue recognition guidance in both Topic 605 and Topic 606, by recognizing implementation expenses in the same period that the vendor would recognize revenue for the implementation activities
 - (e) Analogize to Subtopic 720-45 on business and technology reengineering.
8. A few stakeholders explained that the statement of work for the implementation activities can be complex and is not always detailed or clear. This can make it difficult for an accounting department to identify the components of implementation activities, which adds some complexity to the accounting. However, other stakeholders said the statement of work has sufficient information to identify the components of implementation activities.
9. There were varying opinions about whether there should be different accounting for implementation costs if they are (a) paid to the cloud computing vendor, (b) paid to another third party (for example, a consultant), or (c) considered internal costs (for example, payroll costs for the portion of an employee's time spent on cloud implementation activities).
10. One practitioner said many private companies currently do not have processes in place to track employee time with a sufficient level of detail to capitalize those costs.

Summary of November 16, 2016 Board Meeting

Staff Analysis and Alternatives

11. The staff presented the following two alternatives based on the research and outreach for implementation costs incurred for cloud computing arrangements for which there is not a software license that the customer controls.

Alternative A: Implementation costs associated with a cloud computing arrangement in which there is no software license would be recognized as an expense when incurred

12. Under Alternative A, an entity would recognize as an expense when incurred implementation costs associated with a cloud computing arrangement in which there is no software license. Therefore, both the implementation costs and the hosting arrangement itself would be accounted for like a service contract.
13. The term *implementation costs* is not defined in GAAP; however, the term *implement* is used in GAAP and has a common sense meaning (the process of putting something into place). For example, Subtopic 720-45 refers to “implement internal-use software.” The staff would not be surprised if stakeholders were to request that the Board define implementation costs, particularly if the Board pursues Alternative A. On the one hand, the staff thinks a common sense meaning of implementation costs should be sufficient and creating a special purpose definition for such a generally well understood term would be challenging. On the other hand, the staff thinks there would be some pressure put on how implementation costs would be defined under Alternative A. This is because under Alternative A, some costs would be expensed that otherwise would be recognized as an asset under other Codification Topics. For example, assume as part of its implementation of a new hosting arrangement, an entity engages a consulting firm to write software code to connect or bridge the entity’s sales ledger with the hosting provider’s off-premises customer relationship management system. In the staff’s view, the cost of writing the code would be recognized as software for internal use under Subtopic 350-40 (although there is some diversity in practice, which is why this potential new project has been raised), absent GAAP guidance requiring all implementation costs to be expensed under Alternative A. Consequently, the staff thinks stakeholders would be focused on whether a cost is for an implementation activity or whether it is for some other activity (for example,

a system upgrade that an entity might do even if it had not entered into a hosting arrangement).

14. Proponents of Alternative A think if the underlying cloud computing arrangement is not considered an asset, then the implementation costs associated with the arrangement should not be considered assets. They think there should be consistency in the accounting for the hosting and the implementation of the hosting (that is, if the hosting arrangement is a service contract, then the implementation of that hosting arrangement is a service contract).
15. Some argue that implementation activities for cloud computing arrangements that do not include a license are like business and technology reengineering. Under Subtopic 720-45, the costs of business process reengineering activities, whether done internally or by third parties, are expensed as incurred. However, the staff notes that this guidance does not apply to internal-use software or property, plant, and equipment.
16. Some think one advantage of Alternative A is that it would be the least costly approach, assuming there is not a significant amount of cost associated with determining whether a cost is for implementation activities or some other activities. This is because an entity would not need to separately evaluate each component of the implementation costs, determine which of those costs are an asset, and determine an amortization period for those assets. The staff was informed by some of the stakeholders that the statement of work for implementation activities sometimes is not detailed enough for them to understand the exact nature of the cost. The staff thinks most entities would have a good understanding of the work before signing a contract, although their accounting departments might need to increase their understanding.
17. A disadvantage of Alternative A is that some of the implementation activities meet the definition of an *asset* in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6). Consider the example above that includes implementation activities to write software code. As explained in more detail below under Alternative B, the staff thinks internal-use software meets the definition of an asset under CON 6. Furthermore, Section 350-40-25 provides guidance on internal-use software and requires the asset to be

recognized. Therefore, Alternative A would result in different accounting for the same cost, which might lead to complexity for both preparers and users.

Alternative B: Implementation costs associated with a cloud computing arrangement in which there is no software license would be recognized as an asset or an expense when incurred on the basis of existing guidance in Topic 340, Subtopic 350-40, and Subtopic 720-45

18. Under Alternative B, implementation costs associated with a cloud computing arrangement in which there is no software license would be recognized as an asset or an expense when incurred on the basis of existing guidance in Topic 340, Subtopic 350-40, and Subtopic 720-45. Alternative B uses the existing guidance in GAAP, however, it would create a clearer path for potential capitalization of some of the implementation costs as software code, PP&E, or prepaid assets for upfront payments that are not for a distinct good or service, and, therefore, are a prepayment for the cloud service.
19. As noted in the feedback section, there are several types of implementation costs and the staff thinks that an entity will need to make estimates and judgements to apply Alternative B. This is because under Alternative B an entity might need to separate various components of a single contract and allocate the consideration in the contract to the components. In addition, estimates and judgement would be needed to account for internal costs (for example, payroll), unless Alternative B excluded internal costs. However, the guidance upon which Alternative B is built (that is, Topic 340, Subtopic 350-40, and Subtopic 720-45) has been applied in practice for an extended period of time so many stakeholders already are familiar with it.
20. The staff thinks that a typical financial reporting outcome for implementation costs under Alternative B would be that an entity would recognize (if applicable):
 - (a) Asset(s) for internal use software
 - (b) Asset(s) for property, plant, and equipment (for example, computers)
 - (c) Asset(s) for prepaid costs (for example, an upfront payment made to a consulting firm for services not yet performed or upfront fees paid to a cloud computing vendor for goods or services that are not distinct)
 - (d) Expense(s) for other implementation costs.

21. A disadvantage of Alternative B is that it could be difficult to understand the nature of the activities included in the statement of work for implementation activities.
22. Another potential disadvantage of Alternative B is the risk of inadvertently changing practice in a customer's accounting for other service contracts. In practice today, many companies do not identify multiple components of service contracts, allocate the consideration to those components, and account for each component separately. The staff thinks it is possible that if Alternative B became GAAP for cloud computing arrangements, some would analogize to the guidance for other service contracts.

Summary of January 27, 2017 Working Group Meeting

23. An EITF Working Group, consisting of 18 members (including accounting firms, preparers, vendors, consultants, and a financial statement user) and 3 participating observers (including a representative of the PCC), met on January 27, 2017, to discuss this issue.
24. Overall, the Working Group participant feedback was consistent with the previous outreach and research. Most participants said that the accounting for implementation costs in a cloud computing arrangement that does not include a software license is a pervasive issue, there is currently diversity in practice, and the amounts are often significant. Consequently, the participants said that the FASB should address this issue. However, they have different views on how it should be addressed.
25. Some support capitalizing all or most implementation costs, and some support applying aspects of existing GAAP (for example, guidance on software code, prepaid assets, and PP&E). Some stakeholders that support capitalization of implementation costs do not support presenting those assets as a prepaid asset because they think the subsequent expensing of the assets should be presented in the income statement as an amortization expense. Also, some participants suggested creating an entirely new accounting model for these types of implementation costs (which would allow a path for capitalization as an intangible asset).
26. The staff met with the Not-for-Profit Advisory Committee (NAC) in March 2017 to obtain feedback from the not-for-profit sector on the prevalence of this issue. NAC

members confirmed that this issue is also prevalent and material to the not-for-profit sector and they would like to see guidance provided on these implementation costs.

Questions for the Private Company Council

1. Is the accounting for implementation costs incurred in a cloud computing arrangement unclear and is it a pervasive issue?
2. Are the implementation costs significant for private companies?
3. Do the PCC members have input on the advantages or disadvantages of Alternatives A or B or any ideas for other alternatives?
4. Are there operational concerns or complexities with providing guidance on this issue from a private company perspective (for example, tracking internal costs like payroll)?