IAS 38: Cloud Computing Arrangements

Extract, IFRS Discussion Group Report on Meeting – September 10, 2015

There are various types of cloud computing arrangements in the market place. The following are some common examples:

- Software as a service – This arrangement is a software distribution model where applications are hosted by the service provider and the purchaser has access to the software through a network. The customer maintains all infrastructure and hardware.
- Platform as a service – This arrangement is a model where the cloud provider delivers both hardware and software tools needed for application development. The provider hosts the hardware and software such that the customer does not need to perform installation or purchase in-house hardware and software. This model does not replace the full infrastructure of the customer's needs.
- Infrastructure as a service – This arrangement is a model where virtualized computing resources are provided over the internet. The third party provider hosts the hardware, software, servers, storage and other components on behalf of its users.

Outside of a software license being included in an arrangement, there are other types of possible fees for cloud computing. For example, there could be fees for service, software upgrades, support and maintenance, and internal and external consulting services. Other costs may include website development, development or acquisition of software to be used by the customer, infrastructure purchases and contract acquisition costs. These fees may be bundled together as one fee or individually quoted by the supplier. For example, a monthly fee may include upgrade rights and support and maintenance services.

IFRSs do not contain explicit guidance about a customer's accounting for fees paid in a cloud computing arrangement. However, IAS 38 *Intangible Assets* contains the criteria for recognizing an intangible asset.

Issue 1: When does a cloud computing arrangement with a software license meet the criteria to be capitalized as an intangible asset?

View 1A – Capitalize the fees when the three criteria (i.e., identifiability, control over a resource and existence of future economic benefits) in IAS 38 are met.

Under this view, assuming that the arrangement results in future economic benefits flowing to the entity, the other two IAS 38 criteria of identifiability and control could be met if the arrangement includes certain characteristics. Examples of such characteristics could include the purchaser has a contractual right to take possession of the underlying software at any time during the service period without significant penalty and the purchaser is able to run the software itself or contract another party to run the software.

When the arrangement meets the specified criteria in IAS 38, the software license component of the fees should be capitalized. Otherwise, it should be expensed as a service fee.

If components of both models (i.e., platform as service and software as service) were integrated into an arrangement, the hardware and infrastructure elements would be accounted for in accordance with IAS 16 *Property, Plant and Equipment*.

View 1B – Expense all fees.

This view considers that since IAS 38 is not explicit in stating that cloud computing costs qualify as an intangible asset, the fees should be accounted for as a service contract and expensed.

The Group's Discussion

Group members observed that cloud computing arrangements are becoming more common in practice and noted that IFRSs do not have specific guidance in this area like U.S. GAAP. Group members agreed that if the criteria in IAS 38 are met, the software license should be capitalized as an intangible asset (View 1A). However, there could be multiple elements in the arrangement (for example, training costs) and, thus, identifying what components exist is important to determine the appropriate accounting. Therefore, in addition to considering whether any amounts should be capitalized in accordance with IAS 38 (or IAS 16 depending on the nature of the element), guidance in IFRIC 4 *Determining whether an Arrangement contains a Lease* should also be considered to determine whether lease accounting would apply.

In addition, a cloud computing arrangement may not fit into a specific standard and, thus, entities may need to look at the *Conceptual Framework* to determine whether there is an asset in the arrangement. Entities should focus on identifying whether there is a right to use something rather than just looking at the underlying aspect of the software. If the definition of an asset is met, an entity would need to consider what type of asset the arrangement creates (for example, prepaid, other asset, or intangible asset). One Group member observed that upfront payments are sometimes paid to a third party rather than the cloud provider itself and this fact could have an effect on the accounting treatment as well.

Issue 2: From a customer's perspective, how should fees incurred to enter into a cloud computing arrangement be accounted for (assuming there is no software license element in the arrangement)?

View 2A – Analogize to existing IFRSs that recognize the costs incurred to obtain benefit over multiple reporting periods should be expensed over time.

There is existing guidance in IFRSs (for example, IAS 17 *Leases*) that would support recognizing these costs over the period of future benefit if an analogy can be made.

View 2B – Analogize to development costs and apply the criteria in paragraph 57 of IAS 38 to assess whether the costs should be capitalized.

Although there is no software license element to the arrangement, certain costs relate to development costs such as upfront website development or infrastructure costs.

View 2C – Expense as incurred.

The entire arrangement should be accounted for as a service arrangement and the costs expensed as incurred because there is no software license element.

The Group's Discussion

Some Group members thought that the accounting for the fees paid could be analogized to development costs, thus paragraph 57 of IAS 38 could be applied to determine whether the fees should be capitalized (View 2B). The rationale for this view is that guidance in IAS 38 appears to be more applicable to this situation and the costs incurred may have value that could be transferred or sold to another party.

Other Group members focused on first identifying whether there is an asset and, thus, struggled with applying View 2B. Several questions were raised in terms of whether there is a resource controlled by the entity and whether it is reasonable that the pattern of revenue recognition by the cloud provider could be different from the accounting treatment on the customer's side. In particular, one Group member commented that if it is appropriate for revenue to be recognized over time, it would seem reasonable for the customer to recognize the related cost over time as well. Also, similar to the view expressed under Issue 1, if the definition of an asset is met, an entity would still need to consider the nature of asset that has been acquired in order to determine the appropriate accounting treatment.

Overall, the Group's discussion raises awareness on some of the different types of cloud computing arrangements that are emerging in practice and the complexities involved in determining which standard applies. One Group member suggested that this topic could be revisited by discussing one or more specific fact patterns as each type of cloud computing arrangement could be vastly different. No further action was recommended to the AcSB at this time.

(For a full understanding of the discussions and views expressed, listen to the audio clip[*]).

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[*] Due to technical difficulties, the audio quality is poor and, at times, may not be audible.