

# IFRS 16 and IAS 38: Cloud Computing Arrangements

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## Extract, IFRS® Discussion Group Report on the Meeting – January 10, 2018

The Group initially discussed this topic at its [September 2015](#) meeting. Since then, IFRS 16 *Leases* was issued. The U.S. Financial Accounting Standards Board's Emerging Issues Task Force has also been re-considering the current U.S. GAAP accounting model for cloud computing arrangements (see [project page](#)).

To date, there is no specific guidance in IFRS Standards that addresses the customer's accounting in cloud computing arrangements. In this meeting, the Group focused on the type of cloud computing arrangements in which the customer pays fees to the supplier to access the supplier's hardware and application software. There are certain aspects of IFRS 16 *Leases* and IAS 38 *Intangible Assets* that are relevant in considering the accounting for these arrangements. If these arrangements are not within the scope of either IFRS 16 or IAS 38, the cost would be expensed as the services are provided. The Group discussed five issues using three fact patterns to navigate through the relevant IFRS Standards from the customer's perspective.

### *Fact Patterns*

1. A right to access non-dedicated supplier hardware and supplier application software (Scenario X).
2. Same as Scenario X except the customer has a right to possess a copy of the application software (Scenario Y).
3. Same as Scenario X except the customer specifies particular application software configuration settings (Scenario Z).

### ***Issue 1: Do the arrangements create intangible assets within the scope of IAS 38?***

#### *Analysis*

The definition of an intangible asset (i.e., identifiability, control over a resource and existence of future economic benefits) needs to be considered. Scenarios X, Y and Z would likely satisfy the identifiability and existence of future economic benefits criteria, but it is questionable whether the control criterion is satisfied.

Paragraph 13 of IAS 38 states, in part, that “[a]n entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.” The key issue is how the term “underlying resource” is considered. If the underlying resource is the customer's right of access, the customer has control as others are unable to utilize that customer's specific right. However, if the underlying resource is the hardware and application software, the customer's right of access may not satisfy the intangible

asset definition, absent other arrangement features (i.e., hardware or application software wholly dedicated to the customer).

Assuming that the underlying resource is the hardware and application software, paragraph 4 of IAS 38 supports that the application software should be assessed separately from the hardware because it is not an integral part of the related hardware.

The non-dedicated hardware would fail the definition of control in all scenarios absent other arrangement features. However, the non-dedicated application software may satisfy the control definition in Scenario Y given the customer's right to possess a copy of the application software and restrict the access of others to benefit from that specific copy. For Scenario Z, the question is whether a right to access application software with customer-specific configurations is sufficient to satisfy the control criterion (i.e., create an identifiable version of the software to obtain future economic benefits and restrict the access of others to those benefits).

### *The Group's Discussion*

Based on existing guidance in IAS 38, there were diverse views regarding whether the underlying resource is the customer's right of access or the hardware and application software. Group members acknowledged that establishing what is the underlying resource is a key decision point in determining which IFRS Standard to apply.

A Group member noted that the interplay between IAS 38 and IFRS 16 is problematic. The right of access is something that an intangible asset would represent. However, the right of access is also like a lease in that the customer is leasing the supplier's hardware or software application. Whether the right of access meets the definition of a lease is another question but this interplay makes analyzing cloud computing arrangements challenging.

In terms of assessing the application software separately from the hardware, most Group members agreed with the analysis because these two components of the underlying resource are two separate units of account. This view is predicated on the assumption that the underlying resource is not the customer's right of access.

In considering whether certain characteristics of the arrangement establish an intangible asset, a Group member observed that a right to possess a copy of the application software makes it easier to satisfy the control criterion. However, the arrangements observed in practice thus far are more similar to Scenario Z. A factor to consider in assessing control for Scenario Z is the extent of configuration specified by the customer and the transferability of the configurations after the agreement with the supplier ends.

### ***Issue 2: Do the arrangements or components in Scenarios X to Z meet the definition of a lease in IFRS 16?***

#### *Analysis*

Paragraph 9 of IFRS 16 states, in part, that "[a] contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration."

Paragraph B9 of IFRS 16 indicates that to assess for the right to control, the customer has to have:

- (a) the right to obtain substantially all of the economic benefits from the use of the identified asset; and
- (b) the right to direct the use of the identified asset.

Paragraph B12 of IFRS 16 also indicates that an entity needs to assess whether a contract contains a lease for each potential separate lease component. Referring to the guidance in paragraph B32 of IFRS 16, the right to use an underlying asset is a separate lease component if both:

- (a) the lessee can benefit from the use of the underlying asset on its own or together with other resources that are readily available to the lessee; and
- (b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

The underlying assets in the contract are the hardware and application software. If there are substantive substitution rights, the arrangement would not qualify as a lease.

Further, for Scenario X, it is unlikely that the customer would have the right to obtain substantially all the economic benefits given the potential for others to use the same hardware and application software. Therefore, the arrangement is unlikely to meet the definition of a lease.

For Scenario Y, the hardware component would not satisfy the lease definition given it is not dedicated to the customer. However, the right to possess the application software appears to provide the customer with the right to obtain substantially all the economic benefits from that copy of the application software and the right to direct its use. Based on paragraph B32 of IFRS 16, the application software should be assessed separately from the hardware. The customer's right to possess the application software may indicate that the customer could benefit from the software on its own or together with other available computing resources, and the software is neither highly dependent on, nor highly interrelated with, the hardware in the contract.

For Scenario Z, the hardware component would not satisfy the lease definition. However, there is a question as to whether the customer-specified application software configuration settings create an identifiable version of the software that provides the customer with the right to obtain substantially all the economic benefits and the right to direct its use. In addition, in terms of applying paragraph B32 of IFRS 16, since the customer does not have the right to possess the application software, it is unclear whether the software is considered highly dependent on, or highly interrelated with, the hardware in the arrangement.

### *The Group's Discussion*

A Group member noted that there is overlap between IAS 38 and IFRS 16 with respect to the concept of control. However, under IFRS 16, an entity is determining whether the right of access is a lease and looks at the underlying assets to determine if it has the right to obtain substantially all economic benefits from, and direct the use of, the identified assets.

Group members agreed with the analysis that there is no lease in Scenario X and there is no lease for the hardware component in Scenarios Y and Z. For Scenarios Y and Z, Group members agreed that the definition of a lease should be applied separately to the hardware and application software.

Similar to Issue 1, the right of possession is a persuasive characteristic that could support there is a lease. The extent of customer-specified configuration settings, or the customer's ability to request the return of the configuration settings, which may be akin to having a right of possession, could also support that there is a lease. Group members acknowledged that there are more hurdles to overcome in determining whether there is a lease if the arrangement does not have a right of possession.

An additional point was made that the arrangement needs to provide the customer with the ability to exercise the right to control, and that whether the customer intends to exercise such a right is not relevant.

***Issue 3: Does paragraph 3(e) of IFRS 16 only apply to the licensing arrangements listed therein, or does it apply broadly to all licensing arrangements including software licences?***

IFRS 16 does not define the term "licensing arrangements". However, paragraph 3(e) of IFRS 16 states that the standard does not apply to "rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights." Given the reference to lessee, this scope exclusion seems to indicate that IAS 38 is applied rather than IFRS 16 when a qualifying intangible asset is acquired but the arrangement also meets the definition of a lease.

*View 3A – Paragraph 3(e) of IFRS 16 applies narrowly to the licensing arrangements listed therein.*

Proponents of this view think the scope exclusion is specific to those licensing arrangements listed in paragraph 3(e) of IFRS 16. Other licensing arrangements that qualify as intangible assets and meet the definition of a lease are not automatically scoped out of IFRS 16.

An entity has an accounting policy choice based on paragraph 4 of IFRS 16, which states "[a] lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3(e)."

*View 3B – Paragraph 3(e) of IFRS 16 applies broadly to all licensing arrangements.*

Proponents of this view think that the licensing arrangements in paragraph 3(e) of IFRS 16 are only examples instead of an exhaustive list. Other licensing arrangements that qualify as intangible assets and meet the definition of a lease are automatically scoped out of IFRS 16.

***The Group's Discussion***

Several Group members observed that the words "such items as" in paragraph 3(e) of IFRS 16 supported a broader interpretation that the paragraph applies to all licensing arrangements (View 3B). A few Group members acknowledged that there are arguments for both views.

***Issue 4: Assuming View 3B applies, how does an entity determine whether the arrangement contains a software licence?***

*Analysis*

For Scenario X, the analysis in Issue 2 suggests that the arrangement would not meet the definition of a lease. Therefore, there is no scoping conflict between IFRS 16 and IAS 38.

However, for Scenarios Y and Z, the analysis suggests that the application software component may meet both the definition of an intangible asset and a separate lease component. If this is the case, an entity needs to consider whether such a software component constitutes a licensing arrangement to determine whether it is scoped out of IFRS 16 by paragraph 3(e) of the standard.

Under U.S. GAAP, Accounting Standards Codification (ASC) 350 *Intangible Assets–Goodwill and Others* establishes that for arrangements to include a software licence, they need to meet both of the following criteria:

- (a) The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- (b) It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

*View 4A – To represent a licensing arrangement, the customer must have the right to possess a copy of the software.*

Under this view, if the U.S. GAAP definition was used, the application software lease component would be considered a licensing arrangement in Scenario Y, and therefore, would be scoped out of IFRS 16.

*View 4B – A licensing arrangement is considered broadly as a customer’s right to intellectual property.*

Under this view, there is little economic difference between Scenarios Y and Z. Therefore, the licensing arrangement should encompass the application software lease component in both scenarios.

*The Group’s Discussion*

A few Group members noted that the ambiguity between paragraphs 3(e) and 4 of IFRS 16 makes it difficult to express a view on this issue. To explain, paragraph 3(e) of IFRS 16 explicitly scopes out certain items that meet the definitions of both a lease and an intangible asset. However, paragraph 4 of IFRS 16 indicates that an entity has a choice to apply IFRS 16 to other items outside paragraph 3(e) of IFRS 16 that also meet the definitions of both a lease and an intangible asset. The distinguishing factor between the two paragraphs is unclear, which makes it difficult to understand what the term “licensing arrangements” is intended to capture in paragraph 3(e) of IFRS 16.

***Issue 5: If the arrangement includes an asset that is within the scope of IAS 38 and outside the scope of IFRS 16, what issues arise in measuring the asset and liability?***

*Analysis*

An entity would recognize an asset similar to a right-of-use asset. However, there are many questions around how to measure the liability related to the acquisition of the intangible asset such as determining the term, which payments to include in the measurement of the liability, allocating payments to different components, etc. While there are many issues similar to those encountered in an IFRS 16 lessee model, it is not clear whether it would be appropriate for an entity to apply the guidance in IFRS 16 to an IAS 38 model.

*The Group's Discussion*

Group members agreed with the above analysis that there are many measurement issues to consider if the arrangement is accounted for under IAS 38.

The Group also had a brief discussion about executory contracts (also referred to as supply or service contracts). Absent specific guidance in IFRS Standards, it is possible that some types of cloud computing arrangements could be considered simply executory contracts.

One Group member observed that Scenarios X and Z are difficult to differentiate from an executory contract. However, the right of possession in Scenario Y is a stronger differentiating characteristic that may support recognizing an asset and liability in the Statement of Financial Position. Another Group member agreed that Scenario X is more akin to an executory contract, but thought that in Scenario Z, the existence of customer-specified configuration settings is similar to the “specialized nature” concept for finance leases found in IAS 17 *Leases*. Some Group members thought that it may be reasonable to treat a cloud computing arrangement as an executory contract when there are no rights of possession or extensive customer-specified configuration settings.

In summary, the Group's discussion of Issues 1 to 5 illustrates a thought process that entities can apply when determining the accounting for arrangements in which the customer pays fees to the supplier to access the supplier's hardware and application software. The Group observed that cloud computing arrangements are becoming more prevalent among private sector entities. Given there is no clear guidance in IFRS Standards and the U.S. GAAP model is being reconsidered, the Group recommended that the issues in this agenda item be discussed with the AcSB to determine whether they should be raised to the IASB or IFRS Interpretations Committee.

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