Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service

Extract, PSA Discussion Group Report on the Public Meeting – July 17, 2020

In a cloud computing arrangement, a supplier provides the customer access to software that is not stored on hardware owned or physically located on the customer’s premises. The software may be subject to a long-term licensing arrangement.

The submission focused the Group on accounting for implementation costs related to cloud computing arrangements that are service arrangements. In such arrangements, generally, the software is not customized. The provider has full control of and responsibility for maintenance and upgrades and the customer is prevented from retrieving the software on its own infrastructure. For such cloud computing arrangements that are service arrangements, customers need guidance as to the appropriate accounting under for related implementation costs.

The Group was asked to discuss two issues.

1. Should implementation costs be capitalized as an asset?
2. If implementation costs are capitalized,

   (a) should they be amortized; and

   (b) if so, should the amortization period consider any extension period(s)?

Issue 1

For Issue 1, the Group was asked to consider four views:

A. All implementation costs should be capitalized (using the general definition of an asset).

B. Implementation cost capitalization should be limited to amounts paid to third parties (the implementation costs would be considered a purchased intangible asset other than software).

C. Implementation costs can be capitalized based on the customer's software-capitalization policy (the implementation costs would be considered a software asset as the costs are necessary to activate external software).

D. All implementation costs should be expensed as incurred.

One Group member asked if the benefits related to the implementation costs were transferrable, should the entity change service providers. The submitter indicated that some arrangements are specific to a custom software solution or a provider. For other arrangements, the benefits of the implementation costs may be more transferable, perhaps by module. Another variable in determining transferability of benefits associated with implementation costs may relate to the data's portability from one provider to another.

The Group had mixed views on Issue 1. They were mainly divided between Views C and D. The debate rested on whether control of an asset could be demonstrated in relation to implementation costs incurred. A few Group members indicated that expensing the costs would occur because demonstrating control was not possible and, thus, the definition of an asset would not be met. They noted, however, that this result may not be appropriate given the materiality of investments in such arrangements.

Some Group members were concerned with recognizing implementation costs as an asset when the underlying software to which they relate is an asset of another entity (i.e., the underlying cloud computing arrangement is not capitalized by the customer, but instead is an asset of the provider). Still others concluded an asset did exist, by analogizing to leasehold improvements, or prepaid expenses. Some argued that the implementation costs were necessary to make use of the provider's software. Without incurring implementation costs to activate the computer solution, the cloud computing arrangement would be null. One Group member indicated that the location of the software should not negate the fact that significant costs may have been incurred to use it by the customer. Two Group members were more comfortable with recognizing as an asset only those implementation costs comprising purchases from third parties. This view leverages PSAB's 2019 proposals to allow recognition of purchased intangibles.

In addition, a few Group members indicated discomfort with implementation costs being a general rather than a specific asset.

Some Group members concluded it was possible to argue for each of the views, indicating a need for guidance in the standards, especially for intangibles.

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Issue 2

Issue 2 built on Issue 1, asking if implementation costs are capitalized, should they be amortized? If so, should the amortization consider extension terms? Possible variations in arrangement terms included:

- Month-to-month agreement.
- Fixed five-year arrangement with a customer five-year extension option for a price to be determined at the time of the extension.
- Fixed five -year arrangement with a customer five-year extension option for a pre-set price.

Three views were considered:

A. The amortization period should be limited to the contractual term without consideration of extension options.

B. The amortization period should consider customer extension options included in the service contract.

C. The amortization period should consider potential extensions even in the absence of contractual extension option(s).

The submitter clarified that for the purposes of the discussion it should be assumed that the existence of contractual optional extensions (View B) or the intent by the customer to consider an extension beyond the contract term (View C) would be known on Day 1.

Most Group members concluded that View A was observable and controllable and supported by contract terms, but too conservative. It may, in effect, front-load amortization expense recognition. Nevertheless, one Group member reflected that the rate of change in software may mean that a change in arrangement is possible at the end of the initial period in the contract. Therefore, understanding the magnitude of the customer's investment in and commitment to the arrangement would be needed to justify amortization beyond the initial period in the contract.

Most agreed that View B was the most supportable approach. Several Group members referred to professional judgment in evaluating the substance of the contract for establishing the amortization period. Some Group members saw merit in View C but indicated there would be a burden of proof required as to why amortization should be extended beyond the contract terms. For example, the arrangement's size, if the benefits of the implementation costs are transferable to an arrangement with another provider and the customer's intent would be evaluated in ascertaining if amortization beyond contract terms is appropriate. One Group member also noted that the nature of the implementation costs capitalized, and the future economic benefits expected from them would also be considerations in determining if amortization beyond contract term(s) is appropriate. Useful life and the expectation of future benefits related to any implementation costs capitalized would need to be periodically assessed, as for any long-lived asset.

Another Group member noted that further implementation costs might need to be incurred to maintain the usefulness of the services in either a contractual or assumed extension period. This additional investment would be a factor considered in evaluating the extent to which future economic benefits will be realized from the initial implementation costs incurred.

One Group member noted that the accounting should not create a disincentive for such arrangements. Maintenance and upgrades will be required to ensure the services are provided as agreed and such arrangements tend to be material. So, at a minimum, any extensions in the contract should be considered in setting the amortization period for implementation costs capitalized (View B).

View C may be problematic as service providers will try to increase costs after the initial service period. So, assuming an extension that is not contractual in setting the amortization period may not be appropriate. There may be no financial reason to assume an extension beyond contractual term(s). For a month-to-month arrangement, the amortization period should be determined on Day 1 and regularly reassessed. Another Group member noted that while there may be a preference for specifics in contracts, information-technology costs are dropping. Locking in for fixed rates over set extension terms may mean costs are too high over time, but in return the customer gets consistent accounting over the contract term(s). Alternatively, there may be valid business reasons for choosing a month-to-month arrangement. In evaluating the feasibility of View C's approach, consideration should be given to the customer's expectations and past practices in changing cloud computing providers or arrangements.

Some Group members suggested that an intangibles standard would be useful in resolving the issues discussed. While the submission acknowledged PSAB's opening the door to recognizing purchased intangibles, a full standard on intangibles is needed. Two Group members suggested the Board reconsider the appropriateness of the existing inclusion of software as a tangible capital asset in TANGIBLE CAPITAL ASSETS, Section PS 3150.