A Closer Look at Software Hosting Arrangements

The recently issued Accounting Standards Update (ASU) related to Subtopic 350-40, Intangibles – Goodwill and Other – Internal-Use Software, has led financial statement preparers to review their cloud computing arrangements in search of a software license. ASU 2015-05, Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement, provides guidance to customers about whether a hosting arrangement, as newly defined, includes a software license. Let’s look at the key concepts of the accounting guidance and the importance of reviewing software hosting arrangements in light of the new accounting requirements.

Key Concepts

The underlying premise of the update is basic: Hosting arrangements meeting the update criteria include the right to a software license, and an entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses. The update eliminates the requirement for customers licensing internal-use software to analogize to lease accounting rules. This change results in a company accounting for all software licenses within the scope of Subtopic 350-40 consistent with other licenses of software.

ASU 2015-05 added the term “hosting arrangement” to the Master Glossary, defined as follows:

In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor’s or a third party’s hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

The amendments also state that the guidance applies only to internal-use software to which a customer obtains access in a hosting arrangement if both of the following criteria are met:

1. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
2. 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.

The update has brought a renewed awareness of IT accounting complexities, caused partly by the evolution of cloud computing service offerings.

Software as a Service (SaaS) Versus Hosted Software

In today’s environment, cloud computing arrangements have largely converted the vendor-licensing model to a subscription-based software as a service (SaaS) model. In a SaaS model, the software resides on the remote server of the vendor or another entity; in general, no license is granted to the customer.

Entities access one or more software SaaS applications (most commonly accounting, human resources management, customer relationship management, service desk management, supply chain management and enterprise resource planning) through a standard web browser. Usually, the company executes a subscription-based contract to use the vendor’s proprietary software and in turn receives an authorization code or key for online access. Customers generally purchase only what they need and share IT hardware and storage with other customers.

Since SaaS applications usually don’t include a software license, the guidance in this update normally wouldn’t apply. However, companies shouldn’t assume that it doesn’t; contracts must be reviewed to determine whether they contain elements of software licenses.
Hosted software under the scope of this update is that which is licensed by the company and hosted by the vendor or a third party of the vendor’s choosing. For example, if the hosting arrangement provides the contractual right for the customer to take possession of the software at any time during the hosting period without significant penalty, the company is considered to have purchased a software license, provided it’s feasible for the company to either run the software on its own hardware or contract with a party unrelated to the vendor to host the software. If it’s not feasible for the company to do so, the company hasn’t met requirement B and isn’t considered to have purchased a license.

We expect the update to cause more software licenses to be capitalized, such as certain term-based licenses currently treated as executory contracts by analogy to an operating lease. These entities will see a change in cash flows from operating outflows to investing outflows, a change in operating metrics such as EBITDA, as well as a change in leverage ratios. Time-based licenses with auto-renew options also could create asset measurement challenges.

Software licenses purchased by a company and installed on the company’s own IT platform (or a platform of the company’s choosing) don’t meet the definition of a hosting arrangement. In this situation, a company would follow existing accounting guidance for software licensing.

In the technology realm, arrangements where the company rents an IT platform to run its software generally are termed Platform as a Service (PaaS) and Infrastructure as a Service (IaaS) hosting arrangements. These arrangements are part of the “pay-as-you-go” or “usage-based” cloud computing range of services. Usually, these agreements wouldn’t contain a software element, but they may. For example, the PaaS provider may assist in the development of a new software application. In this situation, the company generally would look to other accounting guidance for the software under development. Often, entities with a PaaS or IaaS agreement have separate software agreements.

Confusion often arises because all SaaS applications are hosted and often are termed “hosted software.” The differentiating factor is that SaaS arrangements generally are service arrangements that don’t involve a license. Hosting arrangements included in the scope of ASU 2015-05, conversely, are arrangements where the software vendor or an unrelated third party hosts software the customer is licensing—and the customer must capitalize.

Reviewing Contracts

Companies encounter the term “license” often, and at times, a “license agreement” doesn’t contain a license. For example, a PaaS or IaaS agreement may include the term “platform licensing costs.” Rental of an IT platform generally represents a service-level agreement (SLA) and not a license agreement.

In another example, a software hosting agreement may include language such as “the software is licensed on a subscription basis.” Entities will need to refer to the new guidelines to determine whether they should account for a software license, meaning they have both the right to take possession of the software without significant penalty and the feasibility to install the software on their own platform.

Arrangements granting access to a vendor’s software over the Internet—both SaaS arrangements and hosting arrangements—may include terms such as “pay-per-usage,“ “pay-per-seat” or “per license fees.” We caution against using the language in the arrangement as the deciding factor when assessing whether the fees are for a service arrangement versus a licensed software hosting arrangement.

Multiple-Component Agreements

Some software-hosting arrangements include one or more licenses to software as well as a contract for the vendor to provide services such as installation, configuration, software customization or ongoing support or hosting services. In this situation, the customer would allocate the contract consideration between capitalized and service elements of the agreement.
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The amount charged by the vendor for software licensing may be the same regardless of whether the vendor’s software is accessed via Internet in a hosting arrangement, defined above, or run on the company’s own hardware or a third party’s hardware of the company’s choosing. This vendor practice of “equal pricing” can lead to the assumption that a hosting arrangement within the scope of this update is an arrangement for a software license only and contains no service component. We recommend consulting with the IT department and the vendor, as needed, to determine the contract elements.

Conclusion

Cloud computing of all types has increased. Entities should take a fresh look at their software contracts and SLAs in light of the new guidance. The IT department and software vendor can be invaluable resources in assessing whether a company has obtained the rights to a software license in a hosting arrangement.

For public business entities, the amendments will be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. For all other entities, the amendments will be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. All entities may adopt the ASU early, and specific transition guidance is given.

Exhibit A: Types of Cloud Computing Arrangements

Cloud service organizations provide subscription-based and provider-managed virtual hardware, software, infrastructure and other related services. In general, these fall into one of three categories:

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<th>Cloud Computing Service</th>
<th>Description</th>
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| Software as a Service (SaaS) | Entails access and delivery of the vendor’s software via Internet  
• Clients generally pay on a subscription basis |
| Platform as a Service (PaaS) | Entails rental of a vendor’s servers and associated services to run company software applications; may also entail rental of services to design, develop, test, deploy and host new applications  
• Clients generally pay for the rental/service on a per-use or utility basis |
| Infrastructure as a Service (IaaS) or Hardware as a Service (HaaS) | Entails rental of the vendor’s hardware, storage, servers and data center space or network components, generally to support a company’s enterprise software applications  
• Clients generally pay for the rental/service on a per-use or utility basis |

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