

# New Cloud Computing Accounting Guidance

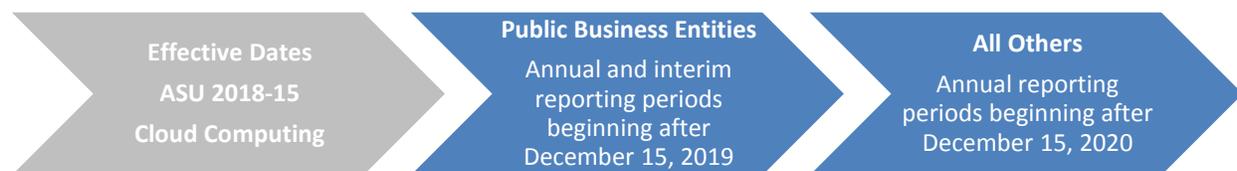
The Financial Accounting Standards Board (FASB) has issued new guidance on how to account for implementation costs related to cloud computing or hosting arrangements. This can include software as a service, platform as a service or infrastructure as a service. Under the new rules, entities are required to capitalize certain implementation costs for cloud computing arrangements using the guidance in Accounting Standards Codification (ASC) 350-40, *Intangibles—Goodwill and Other—Internal-Use Software*.

This new accounting rule is an unusual departure from current generally accepted accounting principles (GAAP), since the costs to be capitalized do not relate to the corresponding recognition of a tangible or intangible asset. However, FASB concluded that while the right to receive hosting services and the obligation to pay for those services are not recognized on the balance sheet, certain cloud computing implementation costs enhance the unrecognized right to receive the related service. These amendments align cost capitalization guidance for hosting arrangements that are service contracts, hosting arrangements that include a software license and the costs incurred to develop or obtain internal-use software.

These changes are effective for 2020 financial statements for public business entities and 2021 financial statements for all other entities. Early adoption is available immediately for all entities.

*Accounting for hosting fees remains unchanged—the fees are expensed as the service is performed.*

*Although the accounting for implementation costs has been standardized, the accounting for the hosting fees will **not** be consistent. In a cloud arrangement that includes a software license, the hosting fees attributable to the software license must be capitalized as an intangible asset with a corresponding liability to the extent the fees are paid over time. In contrast, if a hosting arrangement does not include a software license, the hosting fees are expensed as incurred (see [Appendix A](#)).*



## Background

FASB first addressed cloud computing costs in 2015 when it issued Accounting Standards Update (ASU) 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, which covered hosting arrangements with a software license. ASU 2015-05 amended ASC 350-40 to help entities evaluate whether a hosting arrangement includes an internal-use software license for accounting purposes. If the hosting arrangement includes a license for internal-use software, the software license is accounted for under ASC 350-40. This generally means an intangible asset is recognized for the software license and—to the extent that the payments attributable to the software license are made over time—a liability also is recognized.

If a hosting arrangement does not include a software license, an entity would account for the arrangement as a service contract. Because existing guidance for hosting service contracts is not explicit, diversity in practice has arisen. Some costs can be accounted for using existing GAAP, such as the acquisition of hardware or coding changes to the customer’s on-premise software. Other costs such as customization and configuration of hosted software are not specifically addressed in GAAP and generally are expensed as the services are provided.

As more companies migrate from mainframe systems to cloud computing, and given the substantial implementation costs (that can be as much or more than two to three times the underlying subscription fees),

companies sought additional guidance for arrangements outside of ASU 2015-05’s narrow scope when the hosting arrangement is accounted for as a service contract.

## Scope

ASU 2018-15, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*, broadens the scope of ASC 350-40 with an updated definition of a hosting arrangement that removes the reference to licensing (see table below). FASB concluded a customer’s ability to take possession of the software should not be the key determinant because the functionality of the underlying software—and the customer’s use—is the same regardless of whether the software is delivered through the cloud or an on-premise software license. The customer has an economic resource irrespective of ownership or location of the software.

All hosting arrangements are now considered to have a software element, regardless of whether the arrangement includes a license.

Hosting Arrangement	
Current	ASU 2018-15
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.	In connection with <b>accessing and using</b> software products, an arrangement in which <b>the customer</b> of the software does not <b>currently have</b> possession of the software; rather, the customer accesses and uses the software on an as-needed <b>basis</b> .

## Implementation Costs

Implementation costs incurred in a hosting arrangement are fees incurred by the customer to get the hosted service implemented, set up and ready for use. They may include the cost of software licenses acquired for setup and implementation of a hosting arrangement and software upgrade, enhancement and customization activities. Other implementation costs include training, creating or installing an interface, reconfiguring existing systems and reformatting data.

Costs are capitalized or expensed depending on the nature of the costs and the project stage during which they are incurred, consistent with costs for internal-use software. Costs to develop or obtain internal-use software that cannot be capitalized under ASC 350-40, such as training costs and certain data conversion costs, also cannot be capitalized for hosting arrangements. An entity would expense those costs that are incurred in the preliminary project and post-implementation-operation stages. Costs incurred for setup fees should be accounted for in accordance with guidance in ASC 340 on prepaid assets or other relevant guidance. Costs incurred for integration with on-premise software, coding and configuration or customization are capitalized as intangible assets. Those costs incurred for data conversion and training are expensed as incurred. Any costs for business process reengineering would be accounted for in accordance with ASC 720-45, *Other Expenses*.

## Presentation

Implementation costs capitalized should be presented in the same line item in the statement of financial position that a prepayment of the fees for the associated hosting arrangement would be presented.

## Amortization

Entities are required to expense the capitalized implementation costs over the hosting arrangement's term. The term would include the arrangement's noncancelable period plus periods covered by:

- An option to extend the arrangement if the customer is reasonably certain to exercise
- An option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option
- The vendor's option to extend (or not to terminate) the arrangement

An entity shall consider the effects of all of the following when determining or reassessing the hosting arrangement's term:

- Obsolescence
- Technology
- Competition
- Other economic factors
- Rapid changes that may be occurring in the development of hosting arrangements or hosted software
- Significant implementation costs that are expected to have significant economic value for the entity when the option to extend or terminate the hosting arrangement becomes exercisable

Amortization should begin when the module or component of the hosting arrangement is ready for its intended use, regardless of whether the overall hosting arrangement will be placed in service in planned stages that may extend beyond a reporting period. A module is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, the entity shall begin amortizing the capitalized implementation costs related to that module when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

An entity should use a straight-line basis unless another systematic and rational basis is more representative of the pattern in which the entity expects to benefit from access to the hosted software. The right to access the hosted software is considered equivalent to actual use, which shall not be affected by the extent to which the entity uses—or the expectations about the entity's use of—the hosted software, *i.e.*, number of transactions processed or expected to process or number of users or expected users of the hosted software.

## Presentation

The amortization expense should be presented in the same income statement line item as the hosting arrangement expense; it should **not** be presented along with depreciation or amortization expense related to property, plant and equipment and intangible assets. This is because the asset recognized for the implementation costs is recognized only as a result of enhancing the value of the hosting service, which itself is not recognized as an asset.

## Unit of Account

The ASU identifies the unit of account in a hosting arrangement for amortization, impairment and abandonment as a component or module. Consider an accounting software system that contains three elements: a general ledger, an accounts payable subledger and an accounts receivable subledger. In this example, each element might be viewed as a component or module of the entire accounting software system.

## Impairment

Impairment and abandonment should be evaluated using guidance in ASC 350-40, which references the impairment model in ASC 360-10 on property, plant and equipment. An entity is required to evaluate the capitalized implementation cost of each module of a hosting arrangement for abandonment. The amendments related to abandonment require that a loss be recorded for capitalized implementation costs that no longer provide a future benefit in cases in which a module is no longer used while the core hosted software continues to be used. The guidance is applicable, for example, when one of the following events or changes in circumstances occurs related to the hosting arrangement that is a service contract indicating that the carrying amount of the related implementation costs may not be recoverable:

- The hosting arrangement is not expected to provide substantive service potential
- A significant change occurs in the extent or manner in which the hosting arrangement is used or is expected to be used
- A significant change is made or will be made to the hosting arrangement

## Disclosures

FASB concluded the existing disclosures provide sufficient information to users about implementation costs of a hosting arrangement that is a service contract, supplemented by a description of the nature of an entity's hosting arrangements that are service contracts. ASC 350-40 references other existing authoritative literature, including the following:

- ASC 275 – Presentation, Risks and Uncertainties
- ASC 730-10 – Expenses, Research and Development
- ASC 235 – Presentation, Notes to the Financial Statements
- ASC 360-10 – Property, Plant and Equipment. These disclosures should be made as if the capitalized implementation costs were a separate major class of depreciable asset

Those topics and subtopics require the following disclosures:

- Significant estimates to the extent that, based on known information, it is reasonably possible the estimate will change in the near term and the effect of the change will be material, *i.e.*, impairment, change in useful life
- Total research and development costs charged to expense
- A description of significant accounting policies and the methods of applying those principles that materially affect the determination of financial position, cash flows or results of operations, *e.g.*, amortization method
- Information related to depreciable assets, including:
  - Depreciation expense for the period
  - Balances of major classes of depreciable assets
  - Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date
  - A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets
- Information related to impairment of long-lived assets

## Transition

These amendments can be applied prospectively or retrospectively. Under a prospective transition, an entity would apply the guidance to any cost for implementation performed after the adoption date. An entity may choose retrospective adoption if it had significant implementation costs during the comparative periods presented in the financial statements.

An entity's required transition disclosures will depend on the adoption method chosen. All entities must disclose the nature and reason for the accounting change, the transition method and a qualitative description of the financial statement line items affected by the change. For a retrospective transition, an entity also would disclose the quantitative effects of the accounting change.

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## Appendix A

The GAAP differences related to the hosting fees between hosting arrangements that include a software license and hosting arrangements that are considered service contracts are illustrated in the table below.

Accounting Treatment			
	Internal use software	Hosting arrangement that includes a software license	Hosting arrangement that is considered a service contract
Treatment of implementation costs	ASC 350-40	ASC 350-40	ASC 350-40
Balance Sheet	Intangible asset Liability (unpaid amounts)	Intangible asset Liability (unless fully paid at initial asset recognition)	N/A, or prepaid asset (accrued expense) depending on timing of payments in relation to the service
Income Statement	Amortization expense for the intangible asset Interest accretion on the liability	Amortization expense for the intangible asset Interest accretion on the liability	Operating expense
Statement of Cash Flows	Investing outflows (for prepayments) Financing outflows (principal) and generally operating outflows (interest)	Investing outflows (for prepayments) Financing outflows (principal) and generally operating outflows (interest)	Operating outflows