What you need to know

- The FASB issued new guidance requiring a customer in a cloud computing arrangement (i.e., hosting arrangement) that is a service contract to follow the internal-use software guidance in ASC 350-40 to determine which implementation costs to capitalize as assets or expense as incurred. This may be a change in practice for some entities.

- Capitalized implementation costs related to a hosting arrangement that is a service contract will be amortized over the term of the hosting arrangement, beginning when the module or component of the hosting arrangement is ready for its intended use.

- The guidance is effective for calendar-year public business entities in 2020. For all other calendar-year entities, it is effective for annual periods beginning in 2021 and interim periods in 2022. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued final guidance requiring a customer in a cloud computing arrangement (i.e., hosting arrangement) that is a service contract to follow the internal-use software guidance in Accounting Standards Codification (ASC) 350-40 to determine which implementation costs to capitalize as assets.

The Board said its intent was to reduce potential diversity in practice in accounting for the costs of implementing cloud computing arrangements (i.e., hosting arrangements) that are service contracts. Stakeholders had asked the Board to address this issue after it amended ASC 350-40 in 2015 to include guidance on how to evaluate whether a hosting arrangement includes an internal-use software license.
A customer's accounting for the cost of the hosting component of the arrangement (i.e., service costs it pays for the cloud computing service) is not affected by the new guidance.

**Key considerations**

The new guidance amends the definition of a hosting arrangement and requires a customer in a hosting arrangement that is a service contract to capitalize certain implementation costs as if the arrangement was an internal-use software project. The internal-use software guidance in ASC 350-40 requires the capitalization of certain costs incurred only during the application development stage (e.g., costs of integration with on-premises software, coding, configuration, customization). The internal-use software guidance also requires entities to expense costs during the preliminary project and post-implementation stages (e.g., costs of project planning, training, maintenance after implementation, data conversion) as they are incurred.

That is, under the guidance, a customer applies ASC 350-40 to determine whether to capitalize implementation costs of the cloud computing arrangement that is a service contract or expense them as incurred. The new guidance does not define implementation costs. That's because the Emerging Issues Task Force, which developed the guidance, decided that ASC 350-40 already has appropriate guidance that entities apply in practice to determine which implementation costs qualify for capitalization. The internal-use software guidance states that only qualifying costs incurred during the application development stage can be capitalized. Examples of these costs include:

- External direct costs of materials and services incurred in implementing the hosting arrangement, including fees paid to external contractors (e.g., costs of integrating the hosting arrangement with on-premises software, coding, configuring or customizing software)
- The cost of compensation and benefits for employees for the time they spend on the project’s application development activities (e.g., program coding, testing)
- Interest costs incurred while implementing the hosting arrangement, which should be capitalized in accordance with ASC 835-20

Entities will need to maintain appropriate records to capture the portion of their costs that qualify for capitalization. In most cases, this will require segregating employee time for each project between those activities that must be capitalized and those that must be expensed.

**How we see it**

Entities that historically capitalized implementation costs for internal-use software projects should apply their existing policies and procedures to identify the implementation costs incurred in a hosting arrangement that is a service contract that qualify for capitalization.

Overhead costs, including general and administrative costs, cannot be capitalized. Under the guidance in ASC 350-40-25, training costs (including costs to train employees to develop, configure or implement software) are not related to software development or implementing a hosting arrangement and should not be capitalized. Hence, even if training is required during the application stage, the cost of the training should be expensed as it is incurred.

Entities often implement hosting arrangements that have more than one component or module. For example, a hosting arrangement may support both an employee payroll system and a customer reservation system. In this situation, the payroll system and reservation system may be considered separate components or modules of the hosting arrangement, and the guidance in ASC 350-40 may need to be applied to the individual components or modules. Therefore, an entity may determine that it should separately account for, track and allocate implementation costs to each component or module.
An entity should stop capitalizing implementation costs no later than when the project is substantially complete and ready for its intended use. If an entity determines that it is no longer probable that the project will be completed and placed in service, no additional costs should be capitalized.

**How we see it**

Careful consideration of the services provided by the vendor under a cloud computing hosting arrangement that is a service contract is required to determine the appropriate accounting for the costs a customer incurs. This includes gaining an understanding of the nature of the activities in the arrangement and when they are provided so that the costs are realized in the appropriate period.

**Multiple element arrangements**

In some cases, entities enter into a cloud computing contract that requires them to pay the hosting vendor or other third party to provide implementation activities and other services such as training employees to use the software, maintenance work to be performed by the third party, rights to future upgrades and enhancements, data conversion, and hardware and business process reengineering.

The guidance requires that entities allocate these costs to each element (e.g., configuration, training) based on the relative standalone price of the element in the contract, not necessarily the price that is stated in the contract for each element. The Master Glossary of the Codification defines the standalone price as the price at which a customer would purchase a component of a contract separately. This is a change from the existing guidance in ASC 350-40-30-4 that previously required entities to allocate the cost based on objective evidence of the fair value of the elements in the contract. This change applies to both customers in a cloud computing arrangement that is a service contract and entities that have entered into on-premises, internal-use software projects.

Elements that are in the scope of ASC 350-40 should be accounted for in accordance with that guidance. Elements outside the scope of that guidance should be accounted for based on other accounting literature (e.g., ASC 720-45 on reengineering) or an entity’s fixed asset capitalization policies for items such as computer hardware. Maintenance fees should be recognized as an expense over the maintenance agreement period.

**How we see it**

The FASB did not provide additional guidance on how to determine a standalone price. To allocate fees they pay under a multiple element arrangement, entities will have to use judgment to make a reasonable estimate of the standalone price for each activity.

**Amortization**

Deferred implementation costs are expensed over the term of the hosting arrangement, which is the fixed, noncancelable term of the arrangement, plus any reasonably certain renewal periods. That is, under the new guidance the term includes:

- Periods covered by the customer’s option to extend the hosting arrangement if the customer is reasonably certain to exercise that option
- Periods covered by the customer’s option to terminate the hosting arrangement if the customer is reasonably certain not to exercise that option
- Periods covered by the vendor’s option to extend (or not to terminate) the hosting arrangement
A customer needs to periodically reassess its estimate of the term of a hosting arrangement and account for any change in that term as a change in an accounting estimate in accordance with ASC 250. That is, the estimated term would be revised, and the remaining deferred implementation costs would be recognized over the rest of the period.

When a customer determines and reassesses the term of the hosting arrangement, the guidance says it needs to consider the effects of all of the following:

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

For each module or component of a hosting arrangement, amortization begins when that module or component is ready for its intended use, regardless of whether the overall hosting arrangement has been placed in service.

**Impairment and abandonment**

A customer is required to apply the impairment guidance in ASC 350-40 to the capitalized implementation costs as if the costs were long-lived assets (i.e., the costs must be evaluated for impairment in accordance with ASC 360-10-35).

Additionally, the guidance requires entities to evaluate the capitalized implementation costs related to each module or component of a hosting arrangement that is a service contract for abandonment under ASC 360-10-35-47 through ASC 360-10-35-49, which require an asset to be accounted for as abandoned when it ceases to be used. Entities are required to evaluate long-lived assets as held and used and should determine whether their depreciation estimate must be revised (in accordance with the change in estimate guidance in ASC 250) to reflect a useful life that is shorter than initially expected and a salvage value consistent with the intention to abandon.

**How we see it**

Entities implementing hosting arrangements with multiple modules should consider maintaining cost accumulation and amortization records at the module level so they can begin amortizing the costs for each module at the appropriate time. They will also need detailed cost accumulation and amortization information if they abandon a module in the future while continuing to use other modules under the hosting arrangement. Entities should determine whether they need to change their processes and controls to allocate and accumulate implementation costs for each module.
Presentation and disclosure
The guidance requires a customer to present the expense related to the capitalized implementation costs in the same line item in the income statement as the fees associated with the hosting element of the arrangement, present the capitalized implementation costs 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 and classify payment for capitalized implementation costs in the statement of cash flows in the same manner as payments of the fees for the service component of the hosting arrangement. While there is no guidance on how hosting service fees should be classified on the customer’s statement of cash flows, we believe that payments for hosting fees and capitalized implementation costs generally will be classified as operating cash flows.

The guidance requires entities to disclose the nature of their hosting arrangements that are service contracts and make the disclosures in ASC 360-10 as if the capitalized implementation costs were a separate major class of depreciable asset.

How we see it
While entities will recognize implementation costs incurred in hosting arrangements the same way they recognize implementation costs incurred in internal-use software projects, the financial statement presentation may not be the same. For example, the new guidance will require entities to present capitalized implementation costs for hosting arrangements in the same line item where they would record the prepayment of the hosting fee, but the existing internal-use software guidance does not address where an entity should classify internal-use software implementation costs. As a result, entities may present capitalized implementation costs in a hosting arrangement that is a service contract and capitalized internal-use software implementation costs in different places.

Some entities may already allocate fees for hosting arrangements to different income statement line items based on the nature or function of the service. In these situations, we believe a reasonable and consistent allocation of deferred implementation costs may also be appropriate.

Effective date and transition
For public business entities, the guidance is effective for fiscal years beginning after 15 December 2019, and interim periods within those fiscal years. For all other entities, the guidance is effective for annual reporting periods beginning after 15 December 2020, and interim periods within annual periods beginning after 15 December 2021. Early adoption is permitted, including adoption in any interim period. Entities have the option to apply the guidance prospectively to all implementation costs incurred after the date of adoption or retrospectively in accordance with ASC 250-10-45-5 through ASC 250-10-45-10. The new guidance requires entities to make certain disclosures in the interim and annual period of adoption.

The expense related to deferred implementation costs should be included in the income statement in the same line item as the related hosting fees.
How we see it

• Entities considering prospective adoption that plan to implement a large cloud computing project in the near future may want to early adopt the guidance before the project begins so they can evaluate and account for all implementation costs for the projects under a consistent accounting framework.

• Entities considering retrospective adoption may want to track the implementation costs of existing projects and accumulate the implementation costs of completed projects now so that they have the necessary data for transition.

• Entities should also consider any necessary changes to their processes and internal controls.

Endnotes:

1 Accounting Standards Update (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.

2 ASC 350-40, Intangibles — Goodwill and Other, Internal-Use Software.

3 As amended by ASU 2018-15 and subject to the transition guidance at ASC 350-40-65-3, a hosting arrangement is defined as “[i]n connection with accessing and using software products, an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis.”


5 The term standalone price is used in ASC 842, Leases, and the Master Glossary definition is subject to the transition guidance in ASC 842-10-65-1.

6 ASC 250, Accounting Changes and Error Corrections.