Customer’s accounting for cloud computing implementation costs

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Overview

The Financial Accounting Standards Board (FASB) issued 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 (a consensus of the FASB Emerging Issues Task Force), in August 2018 to align the requirements for capitalizing implementation costs incurred by a customer in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The ASU requires a customer in a hosting arrangement that is a service contract to apply the guidance in FASB Accounting Standard Codification (ASC) Subtopic 350-40 on internal-use software to determine which implementation costs to capitalize and which costs to expense.

Capitalized implementation costs of a hosting arrangement that is a service contract are required to be expensed over the term of the hosting arrangement. The entity also is required to apply the impairment guidance in ASC 350-40 to the capitalized implementation costs. Financial statement presentation of the capitalized implementation costs and related expenses and payments generally should be consistent with the presentation of the fees associated with the hosting element of the arrangement.

Main Provisions

Scope

ASU 2018-15 applies to implementation costs incurred in a hosting arrangement that is a service contract. The definition of a hosting arrangement was modified and is defined in the Master Glossary of the ASC as follows:

In 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.

A hosting arrangement is considered to be a service contract if either: (a) the customer is not contractually allowed to take possession of the software without significant penalty; or (b) it is not feasible for the customer or a third party unrelated to the vendor to run or host the software.

It should be noted that the accounting for the service element of such a hosting arrangement remains unaffected by the issuance of ASU 2018-15.
Capitalization of certain implementation costs

ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred by a customer in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. As a result, customers that incur implementation costs in these situations will be required to apply the guidance in ASC 350-40 on internal-use software to determine which implementation costs to capitalize and which costs to expense. ASC 350-40 requires that all costs incurred in the preliminary-project and post-implementation-operation stages to be expensed as incurred. However, certain costs incurred in the application-development stage will be required to be capitalized. Those costs include those to develop the hosting arrangement as well as certain data conversion costs. Training costs must be expensed as incurred, regardless of the stage in which they are incurred.

A hosting arrangement often will include multiple elements, such as implementation-related items (e.g., software integration, configuration, installation, etc.), hosting and training, among others. When determining the amounts that should be capitalized, entities may not rely on the stated prices for each of these services in the contract and are required to allocate the cost to all elements based on the relative standalone selling price of each element.

RSM commentary

The required capitalization of certain implementation costs (both internal and external) incurred in the application-development stage will require companies to focus more closely on the timing of when implementation costs are incurred as well as their nature. Furthermore, when there are multiple elements in a hosting arrangement, companies also will have to ensure the overall costs are appropriately allocated to each element. This will be a change for many companies and will require increased recordkeeping in order to appropriately account for these costs.

Financial statement presentation

Financial statement presentation of the capitalized implementation costs and related expenses and payments in a hosting arrangement that is a service contract generally should be consistent with the presentation of the fees associated with the hosting element of the arrangement. As a result, the capitalized implementation costs would not be classified as intangible assets on the balance sheet but rather as a prepaid expense, consistent with the classification of any advanced payments for the ongoing hosting element. Further, the income statement classification of the expense for implementation costs would be included in the same line item as the costs incurred for the ongoing hosting element.

Amortization

Capitalized implementation costs are required to be expensed over the term of the hosting arrangement, generally on a straight-line basis. As indicated in ASC 350-40-35-14, the hosting arrangement term is the:

...fixed noncancellable term of the hosting arrangement plus all of the following:

a. Periods covered by an option to extend the hosting arrangement if the entity (customer) is reasonably certain to exercise that option
b. Periods covered by an option to terminate the hosting arrangement if the entity (customer) is reasonably certain not to exercise that option
c. Periods covered by an option to extend (or not to terminate) the hosting arrangement in which exercise of the option is controlled by the vendor.
The estimated hosting term also must be monitored to determine whether a change in the estimated term is necessary. In determining the term of the hosting arrangement, it is noted in ASC 350-40-35-16 that:

An entity shall consider the effects of all of the following when determining the term of the hosting arrangement… and when reassessing the term of the hosting arrangement…

a. Obsolescence
b. Technology
c. Competition
d. Other economic factors
e. Rapid changes that may be occurring in the development of hosting arrangements or hosted software
f. Significant implementation costs that are expected to have significant economic value for the entity (customer) when the option to extend or terminate the arrangement becomes exercisable.

Amortization of capitalized costs should commence when either an independent module or independent component of the hosting arrangement is ready for its intended use. This may occur prior to the point at which the overall hosting arrangement is placed in service. If individual modules or components are dependent on other modules or components, amortization should not commence until the other modules or components are ready for their intended use.

Impairment

Capitalized implementation costs should be tested for impairment in accordance with ASC 350-40 as if the costs were long-lived assets. The unit of account for impairment testing is the asset group level, which is the lowest level for which cash flows are identifiable and largely independent of cash flows of other groups of assets and liabilities. This could result in impairment testing being performed at a higher level than the capitalized implementation costs. Testing is required whenever there are indications that the carrying amount may not be recoverable. Indicators of impairment of capitalized implementation costs that are part of an asset group include situations such as (a) the hosting arrangement no longer being expected to provide substantive service potential or (b) a significant change in (i) the way in which the hosting arrangement is used or expected to be used or (ii) the hosting arrangement itself.

Disclosures

Disclosures required by the ASU include the nature of hosting arrangements that are service contracts as well as the information required by ASC 360-10 as if the capitalized implementation costs were a separate major class of depreciable asset.

Effective date and transition

ASU 2018-15 is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2020 and interim periods within annual periods beginning after December 15, 2021. Early adoption of the ASU is permitted. Entities should apply the changes in the ASU on either a prospective or retrospective basis to all implementation costs incurred after the date of adoption.
RSM commentary

We expect a number of entities that are customers in a cloud computing arrangement that is a service contract that currently expense all implementation costs as incurred will adopt the ASU early so they can begin to defer certain implementation costs.

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