



Q&A

Improvements in Accounting for the Costs of Cloud Computing Implementation

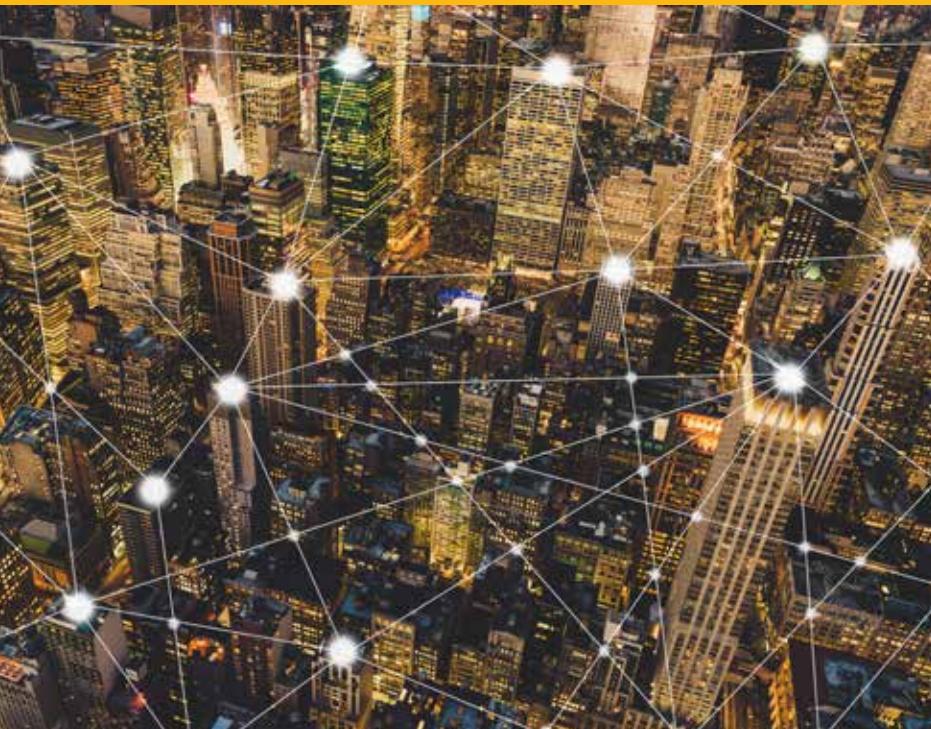
An Interview with Sean Prince,
Glenn Richards, and Matthew Schell

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With the help of new guidance from the Financial Accounting Standards Board (FASB), senior-level financial executives now have clarity on how to account for the costs associated with implementing a cloud computing arrangement, including application development, on-premise coding, testing, configuration, and customization.



The Financial Education & Research Foundation (FERF) spoke with Matt Schell, Sean Prince, and Glenn Richards of Crowe about FASB 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,” which is aimed at decreasing the complexity of accounting for costs of implementing a cloud computing arrangement accounted for as a service contract, as well as about any complexities that remain under the new standard.

FERF: In August, the Financial Accounting Standards Board issued a new standard designed to reduce the complexity of accounting for costs of implementing a cloud computing arrangement accounted for as a service contract. How, specifically, does the new standard reduce the accounting complexity?

Sean Prince: Clearly, one of the largest simplifications the new standard achieves is that it aligns a customer's accounting for implementation costs – such as internal and external spending on coding, testing, configuration, and so forth – across all cloud computing arrangements.

By way of background, in April 2015, the FASB issued another standard, ASU 2015-05, that addressed how customers should account for the fee component of a cloud computing arrangement. And while that standard helped customers understand how to navigate GAAP to account for the fee component of a hosting arrangement, it was silent on the accounting for the related implementation costs for hosting arrangements accounted for as service contracts. That's not to say GAAP was totally silent; there were some relevant topics companies might have been able to analogize to. But, given the lack of explicit guidance for implementation costs, the board decided that it would address the issue through incremental standard-setting.

Matt Schell: I think the important part to understand is that cloud computing arrangements are becoming much more prevalent in practice. With the lack of guidance we had, diversity in practice arose on how entities accounted for these costs. With this ASU, the FASB has aligned everything into the existing ASC 350-40 internal-use software model that companies already have familiarity with and have policies and procedures to handle. The hope is that simplifies things and removes complexity from the system.

FERF: Are there any complexities that remain under the new standard?

Matt Schell: I would probably break the complexities into two buckets. First, as we said before, FASB aligned everything into the internal-use software guidance. In that guidance, there are existing judgments companies have to make in applying certain defined and undefined terms. Examples include the project phases (preliminary, application development, and post-implementation), which drive how the costs are recognized (expense versus capitalization). Although the term "implementation costs" previously was not explicitly addressed, the FASB decided in the new ASU that the term "implementation costs" did not need a definition; instead, the FASB provided a description of the different types of implementation costs that are eligible for capitalization.

Second, this standard includes new things that we haven't had to deal with previously in the internal-use software guidance because the FASB changed some items or added new concepts.

Examples of changes include the definition of a hosting arrangement or the allocation approach for multiple-element arrangements. The definition of a hosting arrangement was changed to remove the word “license” and the requirement that the software resides on the vendor or third party’s hardware; it is uncommon that hosting arrangements provide a license to the underlying software and could have limited the number of arrangements to which this guidance applies.

The FASB also changed the allocation approach for multiple-element arrangements to one in which allocation is based on relative stand-alone price of the elements. Often, up-front payments include implementation costs and other elements – maybe a training element, maybe some hardware elements, some up-front maintenance fees or upgrade fees, or some data conversion costs that we have to break apart. The FASB did not provide additional guidance on how to determine a stand-alone price, and in cases when one is not observable, the customer in the hosting arrangement needs to apply judgment to estimate one.

We also now have more specific requirements about the unit of account for the capitalized costs. The FASB indicated that the subsequent measurements (amortization and impairment) should be tracked at the module or component level. Often, we see that implementation costs for hosting arrangements may have multiple modules, which may be independent of each other and capable of being turned on and off. Accordingly, entities need to evaluate their current cost accumulation and amortization records to evaluate necessary enhancements in their process and controls to accumulate implementation costs at the module or component level.

There is also new guidance on how to determine the amortization period for these capitalized costs. The guidance indicates that we will start with the noncancelable period, and then we have two new screens to think about. One screen includes the options that the customer controls – so those that are reasonably certain of renewal or nontermination by the customer, which might add to the term. The second adjustment is for vendor-controlled options to extend or not terminate.

Sean Prince: I would add one complexity – and this one I would classify as a new complexity: Even though we are aligning the capitalization thresholds for these types of costs, one thing that is going to be different is the presentation of those costs in the financial statements. So, for hosting arrangements that are accounted for as a service contract, the new guidance states that those types of costs should be treated essentially as an operating expense. In other words, they should be put in the same line item as the recurring cost – or fee – for the hosting arrangement. For those that are accounted for as licensed software, historically people have accounted for them as amortization of an intangible asset. Given this difference in financial statement presentation, there may be an incremental need to keep track of the types of arrangements and the related costs to delineate between those that are related to a service-contract-type hosting arrangement and those that are a license-type hosting arrangement to get the presentation on the income statement correct.

FERF: When will people be adopting this standard, and are there any items they should consider when deciding when or how to adopt?

Sean Prince: The new standard takes effect for fiscal years beginning after Dec. 15, 2019, for public companies. That would be 2020 for calendar year-end companies. And private companies get a one-year deferral. The guidance also does permit early adoption, including even early adopting within a quarter versus at the beginning of an annual period.

Regarding transition methods, there are two ways to adopt the new standard. The first is prospectively. In other words, the standard would apply to all implementation costs incurred on or after the adoption date. And the second transition method is full retrospective, which would involve restating prior periods as if the guidance had applied to those periods.

With that in mind, let's think through some potential transition impacts and how that would affect companies' financial statements. Let's assume that you have a large implementation project of a hosting arrangement in process. If you have good records of all the costs incurred to date at the time you adopt the new standard, then you'd likely elect to apply it using the full retrospective approach. That way you could go back with the records you have in hand to capitalize those implementation costs in accordance with the new guidance and achieve comparability across comparative periods.

In contrast, if you don't have the appropriate records to determine what would be capitalizable or not under the new guidance, you could elect to apply the prospective method – that is, you would apply the standard to all implementation costs incurred after the date of adoption.

With respect to early adopting or not, one important determinant will be the quality of the cost information a company keeps. Another key determinant will be whether an organization has a significant implementation project in process or upcoming in the near future. However, regardless of whether a company chooses to early adopt or not, all companies should at least start keeping track of the types of implementation costs being incurred so that when it comes time to adopt they have the option to apply either retrospectively or prospectively.



FERF: You've both touched on this already a bit. How do you expect the changes to impact a company's financial statements and the related financial metrics?

Matt Schell: As Sean mentioned, I think the two obvious impacts are balance sheet presentation and income statement presentation changes. Within the standard, we have explicit guidance on the presentation of most of the basic financial statements – balance sheet, income statement, or cash flows. Some of it speaks to all elements, whether we are talking about the up-front cost payment or the amortization. With a balance sheet, a company might be capitalizing things that it had not been capitalizing before, or it may be capitalizing different things from what it did before. In addition, the guidance indicates that the balance sheet line item for the presentation of these costs should be the same as the line item for the prepayment of fees related to the hosting arrangement, which could mean a new location if the hosting arrangement is not an intangible. For the income statement, the guidance indicates that the expense and fee associated with the hosting arrangement should be presented in a single line item in the statement of income. If the hosting arrangement is not an intangible, then that means the fees paid are not an intangible (or related intangible amortization) and would be a regular operating expense. That resolves one question stakeholders had that made them very focused on this – specifically whether or not these costs are going to hit earnings before interest, taxes, depreciation, and amortization (EBITDA).

A separate and more subtle change will occur in the cash flow statement. This is one of the areas where there is not GAAP guidance on the presentation of hosting fees, but there is guidance that implementation costs should be presented similar to the hosting fees. This means a potential change for some to show those as operating cash flows.

FERF: Stepping aside from the accounting implications, what are the benefits of switching to a cloud environment?

Glenn Richards: In terms of what companies are looking to fix or the benefits, I'll give you four pointers on that. The main one that people usually cite is that 1) with a cloud computing arrangement you have automatic, or easily available, updates and security where the responsibility for updates and security gets placed on the vendor instead of with the company.

Back in my day when dinosaurs roamed the earth there would have been situations where I would go out to a company and it might not have had updates to its security in a decade. That was very possible, and you would see the little blinking green screen that you remember from the show "Lost" or something like that. With a cloud computing arrangement, you get these economies of scale where the vendors are constantly providing updates and security, so you likely get a much better package that way.

The other things that usually come from a cloud security arrangement are, of course, 2) remote access and 3) less of an up-front cost. The path to buying software and installing it on-premises usually involves paying an up-front perpetual license fee and then having an implementation process where the software gets highly customized to a specific company.

The last benefit is the one that a cloud vendor might not highlight in its proposal, but it definitely exists: 4) It forces companies to simplify and ask themselves what they really need. With cloud computing it's usually a package that companies access online, and they tend to go for only things that they really need or want. They think their vendor or IT group will do some customization, and it's so much easier if the customization by the cloud vendor doesn't get out of hand when you think about the fact that all that customization really does have a cost that must be justified that's not only the initial coding but also the maintenance of it.

FERF: What are some of the cloud computing trends that executives should have on their radar?

Glenn Richards: One of the trends that we're seeing in cloud computing is growth in everything. More companies are wanting to use cloud computing arrangements because they offer the benefits that we just talked about (the constant updates, the security, the lower fees up front). It's just enough of an advantage that a lot of people want that.

Now, the flip side to that trend is, of course, if cloud computing is growing everywhere, you have different risks and roles involved. First, there's software that now needs to interact with other software. Where before a company might have had that software entirely on-premises and so its IT group was focused on making different software interact with each other on-site, now you have this complexity where one vendor of yours needs to interact with another vendor of yours. It's a different risk, and your IT group goes from being coding problem-solvers to being managers of getting vendors to interact with each other. And when something goes wrong or doesn't work, how do you manage that if that's just two different vendors pointing at each other?

Another trend that we're seeing is more things being connected. Of course the buzzword is the "internet of things," and the more companies want to push for data coming from everywhere – and you have this growth in cloud computing as well – the more it adds to the number of parties involved and the number of ways that different software needs to interact.

Matt Schell: To that last point, I would emphasize the natural add-on when you outsource is making sure that you have new or adapted controls over everything to ensure that you end up with accurate financial reporting. Think of the number of data breaches that have caused really large problems for companies that happened because a vendor had access to customers' data. It can't be overstated that every time you consider on-site versus cloud, there are incremental management and vendor control and data control considerations.

Ultimately, there is the potential for great economies of scale, but there may be different risk considerations to address as well.



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