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Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract

FASB Accounting Standards Update No. 2018-15 (Issue Date: August 2018)
Link to Standard: Update No. 2018-15

Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-15, *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*, in August 2018.

This update addresses the diversity in practice and aligns the requirements for capitalizing implementation costs incurred in a service contract hosting arrangement with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software.

Accordingly, the amendments in this Update require an entity that is a customer in a service contract hosting arrangement to follow the guidance in Subtopic 350-40, Internal Use Software, to determine which implementation costs to capitalize and which costs to expense.

Background

A cloud computing hosting arrangement is one that does not transfer a software license to the customer. Accordingly, ASC 350 indicates that hosting arrangements are considered service contracts if both of the following are ***not*** met:

- Customer has the right to take possession of the software at any point in the hosting arrangement without significant penalty.
- Customer can feasibly run the software on its hardware or contract a third party to host the software.

Key provisions of ASC 350-40, *Internal Use Software* are provided below.

Capitalization of Costs

ASC 350 provides guidance on which costs to capitalize, relative to the nature of the cost and project stage. A summary of project stages and the associated accounting is shown below.

Preliminary Project Stage	• Internal and external costs shall be expensed as they are incurred.
Application Development Stage	• Internal and external costs incurred to develop internal-use computer software during this stage shall be capitalized. • Costs to develop or obtain software that allows for access to or conversion of old data by new systems shall be capitalized. • Training costs are not internal-use software developments costs and are expensed as incurred. • Data conversion costs are expensed as incurred.
Postimplementation Stage	• Internal and external training and maintenance costs are expensed as incurred.

Customers shall begin the capitalization of costs when 1) the preliminary stage is completed, and 2) when management authorizes and commits to funding a project that is probable to be completed and function in its intended use. If it is no longer probable that the project will be completed and placed into service, then the customer should no longer capitalize costs and should follow the guidance for impairment.

Upgrades and Enhancements Cost

Upgrades and enhancements are defined as modifications to existing software that improves functionality. It requires a change to all or a part of the existing software specifications. Improvements must have a probability that the expenditures would result in additional functionality before costs can be capitalized. Internal costs for upgrades and enhancements should be capitalized or expensed based on the project stage, as highlighted above.

Internal costs for maintenance and uncategorizable items should be expensed as incurred.

External costs for upgrades and enhancements should be capitalized or expensed based on the project stage. If the agreement includes maintenance costs along with upgrades and enhancements, then entities should follow the guidance for multiple-element arrangements.

Multiple-Element Arrangements

Entities may purchase internal-use software or enter into a hosting arrangement where the price includes multiple elements such as software training, maintenance fees by third party, data conversion costs, reengineering costs, and rights to future enhancements and upgrades. In such multiple-element arrangements, entities should allocate costs to each element individually. Previously, entities were required to allocate based on objective evidence of fair value of the elements. This Update requires entities to allocate based on the relative standalone price of the elements, which is defined as "the price at which a customer would purchase a component of a contract separately." If the standalone price is not readily available, entities should follow ASC paragraphs 606-10-32-31 through 32-35 to estimate the price by using the adjusted market approach, expected cost plus a margin approach, or residual approach.

Entities shall begin amortizing the capitalized implementation costs of each module or component of a hosting arrangement once substantial testing is complete and it is ready for use. If the module or component is dependent on other components' completion, amortization begins after all relative components are tested and ready for use.

Amortization

Entities shall amortize capitalized costs over the term of the hosting arrangement on a straight-line basis, unless another method provided more economic benefit. Entities shall determine the term of the hosting arrangement as the fixed noncancelable term plus the following:

- Periods covered by an option to extend the arrangement if the customer is reasonably certain to exercise that option
- Periods covered by an option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option
- Periods covered by an option to extend (or not to terminate) the arrangement in which exercise of the option is in the control of the vendor

Terms shall be reassessed periodically and should account for changes such as obsolescence, technology, competition, rapid development changes, and significant expected implementation costs once an arrangement extension or termination option is exercisable.

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Impairment

Entities should recognize and measure impairment in accordance with ASC 360-10-35. Capitalized cost should be accounted for as if they were a long-lived asset. The following circumstances, in a hosting arrangement, may dictate if the carrying amount is recoverable.

- The hosting arrangement will not produce substantive service benefits.
- A significant change occurs in how a hosting arrangement will be used or expected to be used.
- Future significant changes will be made to a hosting arrangement.

Entities should evaluate abandoned modules or components separately once they cease to be used.

Presentation

Entities must disclose the nature of its hosting arrangements that are service contracts. Presentation of costs should be as follows.

Financial Statement	Presentation
Income Statement	Capitalized implementation costs should be presented the same as fees for hosting element.
Statement of Cash Flows	Payments for capitalized implementation costs should classified the same as fees for hosting element.
Statement of Financial Position	Capitalized implementation costs should be presented the same as prepayments for hosting arrangement fees.

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Insights

The FASB has clearly linked the nature of Cloud Computing Hosting Arrangements with that of Internal Use Software. As a result, the accounting for costs, incurred to make the cloud hosting arrangement useful to the business, are recognized as having a similar ongoing amortizable value and nature as those costs capitalized for Internal Use Software. This new guidance addresses divergent practices that have been used in the past by companies using these hosting arrangements.

Final Thoughts

Entities have the option to choose between retrospective transition and prospective transition. An entity may want to use the retrospective transition approach if implementation costs are significant in comparative periods.

	Effective Date	
	Public Entity	Non-Public Entity
Interim Periods	Beginning after December 15, 2019	Beginning after December 15, 2021

Early adoption is permitted if financial statements were not issued.

Annual Periods	Beginning after December 15, 2019	Beginning after December 15, 2020

Early adoption of the amendments in this Update is permitted, including adoption in any interim period, for all entities. Amendments should be applied either retrospectively or prospectively to all incurred costs after adoption.

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Please look for future updates on other technical accounting matters at www.fidatopartners.com

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