On the Horizon: Accounting for Implementation Costs in Cloud Computing (Hosted) Arrangements

by
Larry Gee
CNM Professional Practice Director

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Overview

Starting in the first quarter of 2020 for calendar fiscal year public companies, FASB Accounting Standards Update (ASU) No. 2018-15, *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*, becomes effective. For nonpublic companies, ASU 2018-15 is effective for calendar fiscal years starting with the annual period for 2021 and then interim periods starting in 2022.

Many companies are using cloud computing arrangements in which their information is stored and processed on a system hosted and managed by a service provider. Often, the system is controlled, maintained, and owned by the vendor, while the company has access to the information as a user. Use of the system to process and store company data is governed by a service contract.

ASU 2018-15 clarifies how a company should account for implementation and setup costs incurred for cloud computing/hosted software arrangements under service contracts. Essentially, the guidance requires such costs to be capitalized in a manner similar to internally developed software. In other words, costs incurred to implement and/or setup the hosted system should be capitalized only during the application development stage of the project. Costs incurred related to the project that are incurred prior to or after the application development stage should be recognized as operating expenses in the period incurred.

Implementation and setup costs during the application development stage occur after a decision has been made to use the software and the vendor selection process is complete. For example, such costs would include internal and external costs incurred to connect the licensed software to other systems owned or licensed by the company, data conversion or mapping costs, and user acceptance testing. However, it would exclude costs incurred to train users on how to use the licensed system. Costs incurred after the licensed system has been placed into production (e.g., maintenance costs) would be recognized as operating expenses as incurred, unless an enhancement is made or implemented that separately qualifies for capitalization (e.g., adds significant functionality).

The capitalized costs should be amortized over the term[1] of the service arrangement and reported in the same line in the income statement as the expense recognized for fees paid under the related service contract for the hosting services. Similarly, the cash outflows should be reported in the statement of cash flows in the line item that would be used for any prepaid fees under the related service contract.

Upon adoption, the guidance in ASU 2018-15 should be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption. Early application of the guidance is permitted.

How has the accounting changed?

Prior to 2016, companies capitalized such costs based on guidance that allowed the accounting used for internally developed software to be applied by analogy to such software licensing arrangements. In April 2015, the FASB issued ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*.

[1] The term of the hosting arrangement includes the noncancelable period of the arrangement plus periods covered by (1) an option to extend the arrangement if the customer is reasonably certain to exercise that option, (2) an option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option, and (3) an option to extend (or not to terminate) the arrangement in which exercise of the option is in control of the vendor.

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ASU 2015-05 revised and narrowed the definition of internally developed software, which excluded arrangements in which the licensee was unable to assume control over the licensed software. In addition, ASU 2015-05 removed the guidance that permitted software licensing arrangements that were deemed service contracts (i.e., did not qualify as internally developed software under the revised definition) to capitalize implementation and setup costs by analogy. The FASB also decided at that time to not address whether implementation and setup costs incurred under a software service contract could be capitalized.

The issuance of ASU 2015-05 raised the question as to whether implementation and setup costs incurred under a software license service contract could be capitalized. Some companies believed that such costs were akin to leasehold improvements in an operating lease and could be capitalized and amortized, while other constituents believed that such costs could not be capitalized under a service contract and should be recognized immediately as an operating expense.

Eventually, a request was made to the Emerging Issues Task Force (EITF) to consider this issue. The EITF concluded that the accounting for implementation and setup costs incurred in a software license service contract should be similar to the accounting for internally developed software, similar to the accounting for such costs prior to the issuance of ASU 2015-05. The EITF conclusion on this issue was later reviewed and ratified by the FASB, resulting in the issuance of ASU 2018-15 in August 2018.

What is the impact of applying the new guidance?

If a company has continued to capitalize and amortize such costs in a manner similar to internally developed software, the adoption of ASU 2018-15 will have little to no impact.

If a company has been recognizing such costs as operating expenses as incurred, they will need to begin tracking implementation and setup costs during the application development stage and capitalize such costs. Then, the capitalized costs will need to be amortized over the term of the hosting arrangement. [2]

[2] The capitalized costs also will be subject to an impairment assessment if and when the company believes that the remaining unamortized balance is no longer fully recoverable, similar to other long-lived assets, by applying the guidance in FASB ASC 350-40 and 360-10-35. For example, if the company subsequently decides to abandon the licensed software (or the asset group of which the licensed software is a component) before the end of the amortization period.

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CNM™ LLP
Technical Advisory Firm

Los Angeles

A | 21051 Warner Center Lane
Suite 140
Woodland Hills, CA 91367
O | 818.999.9501

Orange County

A | 6 Venture
Suite 365
Irvine, CA 92618
O | 949.299.5582

New York City

A | 300 Park Avenue
Suite 12007
New York, NY 10022

San Diego

A | 8910 University Center Lane
Suite 400
San Diego, CA 92122