Cloud Computing Service Contracts: Customer Accounting for Implementation Costs

In order to clarify customer accounting for implementation costs of cloud computing service contracts, the Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) No. 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. The amendments in ASU 2018-15 match the requirements for capitalizing implementation costs of cloud computing service contracts to costs incurred in the development or attainment of internal-use software and for hosting arrangements that include an internal-use software license.

The accounting for hosting/service fees associated with cloud computing service contracts remains unchanged (i.e., the fees are expensed as the service is provided). Hosting arrangements are those that allow customers access to, and use of, software products on an as-needed basis without possession of the software. The hosting arrangement is deemed a service contract, rather than a contract to purchase or license software, if both of the following criteria are not met:

- The customer has the right to take possession of the software at any time during the hosting period without incurring a significant penalty.
- The customer is feasibly able to run the software on hardware that is either its own or that of a contracted third party that is not related to the vendor hosting the software.

As such, customers in a service contract hosting arrangement will follow the guidance in Subtopic 350-40 when assessing which implementation costs to capitalize and which costs to expense; the customer must determine to which project stage an implementation cost relates. Implementation costs incurred in the preliminary project and post-implementation stages are expensed as performed, and costs incurred in the application development stage are capitalized, depending on the nature of the costs:

- Preliminary Project Stage Activities are expensed and include:
  - Conceptual formulation of alternative.
  - Evaluation of alternatives.
  - Determination of existence of needed technology.
  - Final selection of alternative.
- Application Development Stage Activities that are capitalized are:
  - Software configuration/interface.
  - Coding.
Testing (including parallel processing).
Data conversion cost that allows access of old data by the new system.

- Application Development Stage Activities that are expensed are:
  - All other data conversion costs.
  - Training.

- Post-Implementation Stage Activities are expensed and include:
  - Application maintenance.
  - Ongoing support.
  - Training.

Capitalized implementation costs are amortized on a straight-line basis, unless another basis is more representative of the pattern that the customer expects to benefit from using the hosted software. Implementation costs are amortized over the term of the hosting arrangement, and amortization expense is presented on the same statement of income line as the hosting service fees. Amortization for each module of a hosting arrangement begins when it is ready for its intended use (after all substantial testing is complete), regardless of whether the hosting arrangement will be placed in service during planned stages that may go beyond a reporting period. On the statement of financial position, the capitalized implementation costs are presented on the same line as any hosting-fee prepayments. The amortization period includes the noncancelable period of the hosting arrangement and must take into consideration periods covered by the following options:

- Option to extend the arrangement if the customer is reasonably certain to exercise.
- Option to terminate the arrangement if the customer is reasonably certain not to exercise.
- Option that is controlled by the vendor.

Customers should periodically reassess the estimated amortization period and account for any prospective change as a change in estimate. When determining and reassessing the term of the hosting arrangement, consideration should be given to obsolescence, technology, competition, other economic factors, rapid changes in the development of hosting arrangements or hosting software, and significant implementation costs that are expected to have considerable economic value for the customer when the option to extend or terminate the hosting arrangement becomes exercisable.

Additionally, capitalized implementation costs are subject to existing impairment guidance in Subtopic 350-40 (i.e., the capitalized implementation costs are treated as long-lived assets). If the hosting arrangement for internal-use software includes multiple elements (e.g., hosting, software training, third-party maintenance fees, data conversion costs, reengineering costs, and rights to future upgrades and enhancements), customers are to allocate implementation costs to individual elements based on each element’s relative standalone price, which may not necessarily be the price stated in the vendor’s contract.

The amendments of ASU 2018-15 are effective for:

- Annual reporting periods beginning after December 15, 2019, for public business entities.
- Annual reporting periods beginning after December 15, 2020, for all other entities.

Early adoption is permitted for all entities, including adoption in any interim period. Entities may apply the guidance prospectively, to all implementation costs incurred after adoption, or retrospectively.

For more information about customer accounting for implementation costs of cloud computing service
contracts, contact one of our PYA executives below at (800) 270-9629.

© 2019 PYA
No portion of this article may be used or duplicated by any person or entity for any purpose without the express written permission of PYA.