INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

WHY CAPITALIZING CLOUD COMPUTING COSTS MATTERS FOR TECH COMPANIES

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Cloud computing's versatility, speed and reliability helps today's high-growth tech companies build and maintain strong operational roots as they work to scale for sustained growth. Cloud services allow tech companies to focus on other areas of innovation instead of allocating precious resources to managing internal software.

A recently issued accounting standards update now clarifies that many of the significant costs incurred during cloud solution implementations should be capitalized and amortized, rather than immediately expensing such costs, which has been the case for many companies until now.

THE RISE OF CLOUD COMPUTING

During the past few years, tech companies have increasingly adopted cloud computing arrangements (hosting arrangements) for a variety of business operations in place of third-party sourced or internally developed software, and thereby avoided the often-substantial upfront costs of software and the necessary hardware infrastructure. However, the generally accepted accounting principles in the United States (GAAP) did not provide any specific guidance regarding the accounting for implementation costs incurred for hosting arrangements, which led to diversity in the accounting treatment of such costs. As a result, some tech companies expensed all such hosting arrangement costs as incurred, while other companies capitalized some implementation costs based on an analogy to or the application of other areas of GAAP.

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In April 2015, the FASB issued Accounting Standards Update (ASU) 2015-05[1] to clarify whether, for accounting purposes, a hosting arrangement includes a license for internal-use software. ASU 2015-05 directed companies to account for software licenses included in hosting arrangements in accordance with ASC 350-40[2] (i.e., generally capitalize and subsequently amortize the cost of the license and recognize a liability for future payments associated with the software element). ASU 2015-05 further clarified that if a company's hosting arrangement does not contain a software license based on the criteria defined in ASC 350-40, the company should account for the hosting arrangement as a service contract; however, ASU 2015-05 did not include specific guidance regarding the accounting for implementation costs incurred for hosting arrangements that are service contracts.

After the issuance of ASU 2015-05, stakeholders requested additional guidance on accounting for implementation costs associated with hosting arrangements that do not contain a software license and, therefore, are considered service contracts. Frequently, hosting arrangements that are service contracts contained significant implementation costs and the absence of guidance on such implementation costs created diversity in practice. That is, some companies capitalized and subsequently amortized implementation costs while other companies expensed implementation costs when incurred. The FASB issued ASU 2018-15[3] (the Update) to address this diversity.

IMPACT OF THE NEW ACCOUNTING STANDARD UPDATE

Upon adoption of the updates in ASU 2018-15, tech companies will account for implementation costs in a hosting arrangement as follows:

Capitalization model

The Update requires companies to apply the existing model in ASC 350-40 when evaluating implementation costs in software hosting arrangements that are service contracts for capitalization. Essentially, the implementation costs incurred in hosting arrangements will be treated the same irrespective of whether the hosting arrangements include a software license or consist only of a service contract.

Accordingly, qualifying internal and external costs incurred during the application development stage (as described in ASC 350-40) should be capitalized, while costs incurred during the preliminary and post-implementation stage should be expensed as incurred. Under the Update, hosting fees in hosting arrangements that are service contracts would continue to be expensed as long as the hosting service is performed.

The following development phase costs should be capitalized:

- External direct costs of material and services consumed in developing or obtaining internal-use software
- Payroll and related costs for employees who devote time to and are directly associated with the project
- Interest costs incurred while developing internal-use software
- Costs of enhancements or upgrades of the system

Expenses that should NOT be capitalized:

- General, administration, and overhead costs
- Inefficiencies or operating losses incurred during software implementation
- Training costs, costs of systems maintenance, updates, and minor modifications
- Fees paid to outsiders for general systems consulting and overall control reviews

Expense recognition and impairment

Implementation costs capitalized in accordance with the Update are amortized over the estimated term of the hosting arrangement, which includes renewal options that are reasonably certain to be exercised. Companies are required to periodically reassess the estimated term of the hosting arrangement, and account for changes in the estimated term, as a change in accounting estimate. Furthermore, capitalized implementation costs should be tested for impairment by applying the impairment model described in ASC 360-10[4]. Companies are also required to record an abandonment loss for capitalized implementation costs if the associated module or component is no longer used.

Financial statement presentation

Capitalized implementation costs should be presented in the same line item on the balance sheet as the prepayment for the fees of the associated hosting arrangement. Similarly, the income statement should reflect the amortization expense related to the capitalized implementation costs in the same line item as the fees associated with the hosting element of the arrangement. Accordingly, amortization expense related to those implementation costs cannot be presented along with depreciation or amortization expense for property, plant and equipment and intangible assets if such depreciation or amortization is presented separately in the income statement.

1 Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

2 Intangibles—Goodwill and Other—Internal-Use Software

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

4 Property, Plant and Equipment

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Also, payments for capitalized implementation costs should be classified in the statement of cash flows consistent with payments made for the fees associated with the hosting arrangement.

Disclosure updates

Under the Update, companies are required to make the same disclosures as required for internal-use software with the addition of a description of the nature of the companies' hosting arrangements that are service contracts. Companies should also provide disclosures in ASC 360-10 as if the capitalized implementation costs were a separate major class of depreciable asset.

Transition

For public business entities, the Update is effective in fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. All other entities have an additional year with early adoption permitted for all entities. The Update provides companies the option to choose between a prospective and retrospective transition approach. That is, the Update can be applied prospectively to all implementation costs incurred after the date of adoption or retrospectively.

IMPLICATIONS FOR THE TECHNOLOGY INDUSTRY

Some implications of the FASB's Update for tech companies include:

Assessment of processes and controls

When determining which costs to capitalize, tech companies will now have to consider the nature of their hosting arrangement implementation costs as well as the project stage in which those costs are incurred. Tech companies' management teams should perform a critical assessment of the processes, systems and controls used to track and classify implementation costs, and if necessary, make enhancements. Furthermore, the project managers of cloud-based solutions should be familiarized with the project stage and qualifying cost concepts described in ASC 350-40 to better enable the preparation of documentation necessary to identify costs that qualify for capitalization.

Significant judgment may be required

The Update may require that management exercise significant judgment when estimating the period of time over which capitalized implementation costs should be amortized (factoring in the likelihood customer exercises any option to renew or terminate early the hosting arrangement) and whether capitalized implementation costs are subject to impairment.

Communications with investors, lenders and other stakeholders

To the extent that ASU 2018-15 could significantly impact companies' financial statements, companies will need to anticipate any changes to earnings in order to set expectations for investors, lenders and other stakeholders. Management teams may also need to discuss the effect of the Update with lenders to evaluate the need for any changes in debt covenants that may be affected by the capitalization of implementation costs.

Income taxes

The change in timing of recognition of implementation costs may result in changes to current taxable income. The Update may also impact a company's deferred taxes. Since a company's income tax accounting depends on specific facts and circumstances, tech companies may find consulting with a tax advisor useful.

GOING FORWARD

Prior to the Update, the difference in accounting treatments for implementation costs incurred in hosting arrangements (expense when incurred) and perpetual software license (capitalize) made hosting arrangements less attractive to some customers, despite many of the benefits of the hosted delivery model.

With the FASB's Update, many cloud computing vendors will enter a more level playing field when marketing their hosted solutions since many implementation costs will no longer represent an upfront expense to customers. Instead, tech companies' implementation costs can be capitalized and amortized over the estimated economic life of the hosting arrangement.

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