

Memo 3 - Appendix A

Memo No. **Issue Summary No. 1***

Issue Date **July 7, 2017**

Meeting Date(s) **EITF July 20, 2017**

Contact(s)	Jaime Dordik	Project Lead / Author	(203) 956-5212
	Rob Moynihan	EITF Coordinator	(203) 956-5239
	Dillon Jones	Postgraduate Technical Assistant / Co-Author	(203) 956-5298
	Cullen Walsh	Assistant Director	(203) 956-5354
	Robert Uhl	EITF Liaison	(203) 761-3152
Project	Issue No 17-A, "Customer's Accounting for Implementation, Setup, and Other Upfront Costs (Implementation Costs) Incurred in a Cloud Computing Arrangement That Is Considered a Service Contract"		
Project Stage	Initial Deliberations		
Issue(s)	Issue 1 – Definition of implementation costs		
	Issue 2 – Scope of the project		
	Issue 3 – Accounting for implementation costs incurred in a cloud computing arrangement that is considered a service contract		
	Issue 4 – Useful life (if applicable)		
	Issue 5 – Analogizing to other service contracts		

Memo Purpose

1. The purpose of this memo is to assist the Task Force in addressing several accounting issues related to a customer's accounting for implementation costs incurred in a cloud computing arrangement (CCA) that is accounted for as a service contract under the amendments in Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* (Update 2015-05). The staff is not planning to complete deliberations on this issue at the July 20, 2017 EITF meeting. The deliberations are expected to continue at the September 14, 2017 meeting when the Task Force could discuss any remaining open issues, implementation guidance (if applicable), as well as transition and disclosure requirements.

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Questions for the Task Force

1. Does the Task Force want to include a definition of the term *implementation costs* within the Master Glossary of the Codification? If not, does the Task Force want to include examples of implementation costs in the Codification?
2. Does the Task Force agree with the scoping approach developed by the staff?
3. Which accounting alternative does the Task Force want to select? Is there further research that the Task Force requests about the alternatives? If the Task Force selects Alternative B, does the Task Force want to provide guidance on how to allocate contract consideration to various elements in a contract?
4. If the Task Force selects Alternative B, does the Task Force want to provide guidance on useful life?
5. Does the Task Force have any input about applying the guidance by analogy to other types of service contracts?

Background

2. In April 2015, the FASB issued Update 2015-05, which provides guidance about a customer's accounting for hosting fees paid in a CCA. Examples of CCAs include software-as-a-service (SaaS), platform as a service, infrastructure as a service, and other similar hosting arrangements. A SaaS arrangement uses internet-based application software hosted by a service provider or third party and is the most common CCA.
3. The amendments in paragraph 350-40-15-4A of Update 2015-05 provided the following two criteria, which already were included in Subtopic 985-20, Software—Costs of Software to Be Sold, Leased, or Marketed, and are applied by cloud service providers to determine when an arrangement includes the sale or license of software for purposes of revenue recognition:
 - a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
 - b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.
4. If a CCA includes a license to internal-use software, then the software license is accounted for by the customer in accordance with Subtopic 350-40. This generally means that an asset is recognized for the software license and amortized over its useful life. If a CCA does not include a license to internal-use software, the entity would account for the arrangement as a service contract. This generally means that the hosting costs are expensed as incurred.

5. Some stakeholders have stated that GAAP is unclear about the accounting for implementation costs for a CCA for which there is not a software license. Implementation costs include setup and other upfront fees to get the arrangement ready for use. Other implementation costs can include training, creating, or installing an interface, reconfiguring existing systems, and reformatting data.
6. In comment letters on the exposure draft that resulted in Update 2015-05, several stakeholders requested additional guidance on accounting for implementation costs associated with CCAs that do not meet the criteria listed above and, therefore, are considered service contracts. Stakeholders explained that without explicit guidance, diversity in practice would continue in accounting for these implementation costs.
7. When the Board was redeliberating the proposal that resulted in Update 2015-05, the Board decided not to expand the scope of the project to address a customer's accounting for the implementation costs incurred by customers who enter into CCAs that are accounted for as service contracts. One of the Board's considerations was that accounting for implementation costs was beyond the scope of the financial reporting issue that the Board was trying to address in the project. Some Board members observed that changing the scope of the project to include implementation costs might require re-exposure of the proposal, which would delay resolving the initial issue the Board was attempting to resolve. Paragraph BC7 of the Basis for Conclusion of Update 2015-05 states:

...to the extent that a cloud computing arrangement transfers a software license, Subtopic 350-40 provides guidance on how to account for costs such as those resulting from training, data capture and conversion activities. In deciding not to provide additional guidance on the accounting for upfront costs incurred by customers entering into cloud computing arrangements that do not transfer a software license to a customer, the Board noted that initial costs incurred in service arrangements are not unique to a cloud computing arrangements. Consequently, the scope of that issue is much broader than cloud computing arrangements. The Board decided that the scope of this Update should not be expanded to address the range of implementation and set-up costs incurred by a customer in a cloud computing arrangement.
8. After Update 2015-05 was issued, several stakeholders contacted the FASB staff requesting that the Board provide additional guidance on accounting for implementation costs incurred in a CCA that is considered a service contract. They told the staff that there is currently diversity in practice, and that entities look at different areas of the Codification for guidance on how to account for these other implementation costs incurred in a CCA that is accounted for as a service contract because there is currently no explicit guidance on them.
9. Additionally, some stakeholders said that capitalizing certain of these implementation costs would more faithfully represent the economics of the transaction because these implementation costs are identical to those incurred in an on-premise software license. GAAP already includes

guidance in Subtopic 350-40 for implementation costs for software arrangements that include a license. Under that guidance, some costs are expensed and some are capitalized. Some stakeholders do not think the accounting for implementation costs should vary depending on whether the implementation costs are for an arrangement that includes a software license that the customer controls or for an arrangement that does not include a license that the customer controls.

GAAP in Other Jurisdictions

10. IFRS does not contain explicit guidance about a customer's accounting for CCAs or implementation costs for those arrangements. IAS 38, *Intangible Assets*, provides criteria for recognizing an intangible asset, and the FASB staff believes that entities would apply IAS 38 at least to the CCA itself. The staff has heard from a couple of U.S. practitioners that there is diversity in practice under IFRS because of the absence of explicit guidance.
11. The Canadian Accounting Standards Board's IFRS Discussion Group in its "Report on Meeting—September 10, 2015,"¹ IAS 38: Cloud Computing Arrangements,"² included some varying views on the issue of accounting for the implementation costs associated with CCAs. One view is that implementation costs are an intangible asset that should be capitalized in accordance with IAS 38 when the following three criteria are met:
 - (a) Identifiability
 - (b) Control over a resource
 - (c) Existence of future economic benefits.

Under this view, if the three criteria are not met, then the implementation costs are expensed as a service fee.

12. Another view from that report is that since IAS 38 does not explicitly state that cloud computing costs qualify as an intangible asset, the implementation costs should be accounted for as a service contract and expensed as incurred.
13. In these discussions, the IFRS Discussion Group members noted:

...cloud computing arrangements are becoming more common in practice and noted that the IFRSs do not have specific guidance in this area like U.S. GAAP. In addition, a cloud computing arrangement may not fit into a specific standard and, thus, entities may need to look at the Conceptual Framework to determine whether there is an asset in the arrangement. Entities should focus

¹ The IFRS Discussion Group was established by the Canadian Accounting Standards Board to implement and maintain a regular public forum to discuss issues that arise in Canada when applying IFRSs.

² <http://www.frascanada.ca/international-financial-reporting-standards/ifrs-discussion-group/search-past-meeting-topics/item82511.pdf>

on whether there is a right to use something rather than just looking at the underlying aspect of software. If the definition of an asset is met, an entity would need to consider what type of asset the arrangement creates (for example, prepaid, other asset, or intangible asset)

14. Another issue raised by the IFRS Discussion Group was how to account for the implementation costs in a CCA that do not meet the criteria to be capitalized. There were differing views on the accounting for these costs including the following:
 - (a) Analogize to existing IFRS guidance that recognize costs incurred to obtain benefits over multiple reporting periods that should be expensed over time (for example, leases).
 - (b) Analogize to development costs and apply the criteria in paragraph 57 of IAS 38 to assess whether these costs should be capitalized.
 - (c) Expense implementation costs as incurred because there is no software license element.
15. The discussion raised awareness about some of the different types of CCAs that are emerging in practice and complexities in determining which standard applies. While one member of the IFRS Discussion Group recommended that the topic be revisited, no further action was agreed upon at the time of the meeting. Furthermore, the IASB is not currently working on a research project on CCAs.

Staff Outreach

16. In response to stakeholder feedback, the staff performed research and outreach to determine whether there is a narrow improvement that can be made to GAAP to reduce diversity in practice, which would result in more comparable information for investors and less cost for the financial reporting system.
17. The staff outreach included individual meetings and a working group meeting (the EITF Working Group). The staff spoke with six accounting firms, seven preparers who are customers to CCAs, one industry group, five vendors, four consultants, and one financial statement user. The staff also spoke with two of the FASB's Advisory Committees (Not-for-Profit Advisory Committee (NAC) and the Private Company Council (PCC)).
18. All of the accounting firms, the industry group, and one consultant noted that implementation costs associated with CCAs that are not within the scope of Subtopic 350-40 have increasingly been brought to their attention because of the omission of guidance in the amendments in Update 2015-05 and the expansion and prevalence of cloud computing services.

19. Most stakeholders said that companies currently analogize to different areas within the Codification to account for implementation costs incurred with CCAs that are considered service contracts, including the following:
- (a) Expense all or most implementation costs associated with CCAs that are considered service contracts
 - (b) Analogize to Subtopic 350-40 on internal-use software for implementation costs incurred to integrate (bridge) the CCA with the existing on-premise software
 - (c) Analogize to Topic 340, Other Assets and Deferred Costs, for certain upfront fees
 - (d) Analogize to the revenue recognition guidance in both Topic 605 and Topic 606, by recognizing implementation expenses in the same period that the vendor would recognize revenue for the implementation activities
 - (e) Analogize to Subtopic 720-45 on business and technology reengineering.
20. A few stakeholders explained that the statement of work for the implementation activities can be complex and is not always detailed or clear. This can make it difficult for an accounting department to identify the components of implementation activities, which adds some complexity to the accounting.
21. Several participants currently expense all implementation costs as incurred in a CCA that is considered a service contract. These participants said that since they do not account for the arrangement in accordance with Subtopic 350-40, they consider the implementation costs to be part of the service contract. One consultant said that there has been less diversity since the issuance of Update 2015-15, and more companies now expense implementation costs as incurred.
22. Two accounting firms, the advisory firm, and the industry group said that companies capitalize the portion of implementation costs associated with the CCAs (that are considered service contracts) that are incurred to integrate (bridge) the CCA with their existing internal-use software or make improvements to their current on-premise software for the CCAs to work seamlessly.
23. Several stakeholders said they record prepayment of implementation costs for setup and upfront fees incurred in the CCA as a prepaid asset under Topic 340. Several accounting firms said their clients analogize to various sections of Topic 605 and Topic 606 to recognize the expense in a way that is consistent with the pattern that the vendor would use to recognize revenue.
24. Two accounting firms said their clients analogize the accounting for CCAs to the guidance in Subtopic 605-25, Revenue Recognition—Multiple-Element Arrangements, and separate the

multiple elements of the CCAs, specifically the implementation costs and the hosting fees. Those firms said that their clients then refer to Subtopic 350-40 and capitalize certain implementation costs in conformity with that guidance.

25. In a similar vein, one accounting firm suggested that the FASB should consider providing guidance on whether the implementation costs represent a promised good or service, or a setup fee. They suggested having symmetry in the accounting treatment for implementation costs incurred in a CCA considered a service contract with the revenue guidance in paragraph 606-10-25-17, which states:

Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contact with the customer.

26. Several accounting firms and the industry group said that implementation costs should be capitalized if they meet the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6).
27. There were varying opinions about whether there should be different accounting for implementation costs if they are (a) paid to the cloud computing vendor, (b) paid to another third party (for example, a consultant), or (c) internal costs (for example, payroll costs for the portion of an employee's time spent on cloud implementation activities). Some stakeholders said they account for the costs differently depending on whether they are incurred by the entity internally, by a third-party consultant, or by the vendor. Several of these participants questioned whether there should be accounting guidance for implementation costs that are incurred internally and different accounting guidance for implementation costs that are incurred externally by the hosting vendor or a third-party consultant. An accounting firm said that it has clients who expense all costs paid to a third-party consultant as incurred, but would potentially record the implementation costs paid to the hosting vendor as a prepayment of the services to be performed and recognize the expense over the term of the arrangement.
28. Overall, most participants in the EITF Working Group recommended that a narrow-scope project be added to the Board's agenda. One vendor said that the implementation costs incurred in a CCA are disproportionately large in relation to the overall arrangement, and generally are paid up front. That is not generally the case for other types of service contracts.

Issues

29. The Board decided to add a narrow-scope project to the EITF's agenda with the purpose of clarifying the accounting for implementation costs incurred in a CCA that is considered a service contract.

Definition of Implementation Costs (Issue 1)

30. At its November 16, 2016 meeting, the Board raised some concerns about the term *implementation costs* within the context of this project because it is not a defined term in the Codification, and one Board member questioned whether standard setting in this area would be effective without a clear definition. The approach used to decide whether a prescriptive definition should be provided, or whether other explanatory language or examples should be provided, could inform the Task Force's thinking on the accounting alternative.

Stakeholder Feedback

31. At the January 2017 EITF Working Group meeting, a few EITF Working Group participants expressed concerns with distinguishing implementation costs from other costs when evaluating contracts. Specific concerns included the following:
 - (a) During negotiations, vendors may change the stated pricing terms to meet the customer's preferences, which could include building the upfront/implementation fees into the monthly service fee
 - (b) Not all contracts provide a detailed breakdown of the costs and, therefore, it can be difficult to distinguish among administrative costs, implementation costs, and hosting costs. However, the staff noted that if this were the case (and continued to be the case), then standard setting in this area likely would not be possible or productive.
32. Ultimately, most EITF Working Group participants asserted that the implementation costs in these types of arrangements are generally well understood and can be determined from the CCA contract for the following reasons:
 - (a) Implementation costs in a CCA are similar to those incurred when implementing a software license, which has specific guidance in Subtopic 350-40 and which entities apply today
 - (b) If specific accounting guidance was provided on implementation costs in CCAs, vendors and customers would work to ensure that the contracts have sufficient detail to allow the customer to separate implementation costs
 - (c) Topic 606 requires a vendor to differentiate between setup activities and performance of distinct goods or services, which may assist customers in determining the type of costs.

33. Following the May 2017 Board meeting, the staff performed additional outreach with several EITF Working Group participants to ascertain their thoughts on including a prescriptive definition of the term *implementation costs* in the Master Glossary. None of the participants thought that a prescriptive definition should be included in the Master Glossary. Almost all stakeholders explained that there are many different types of CCAs, which would make it difficult to capture the varying types of implementation activities within a prescriptive definition.
34. Additionally, several participants explained that due to the pace at which technology is changing, the types of implementation activities (and the names used in the marketplace to describe those activities) are likely to change as well. Therefore, a prescriptive definition could quickly become outdated.
35. Almost all outreach participants suggested including explanatory language in the Codification that would provide examples of costs that would be considered implementation costs and potentially capitalizable. One preparer elaborated on that suggestion indicating that broad, principles-based language on implementation costs would be more preferable than including a prescriptive definition. That language could be that implementation costs are those costs incurred to get the hosting arrangement ready for its intended use, and could include an example of such costs.
36. If examples of implementation costs are included in the guidance, an accounting firm suggested that the explanatory language could state that “the examples are not all inclusive” or “implementation costs are not limited to the examples.” Another accounting firm suggested providing a tabular presentation or a matrix of what would be considered an implementation cost, similar to what is included in Subtopic 720-45 on business process reengineering.
37. One preparer participant suggested providing examples of the types of costs that would *not* be considered implementation costs (referred to by this participant as a “negative definition”). When the idea of a negative definition was discussed with other EITF Working Group participants, there was general agreement that this would be a better approach than including a prescriptive definition.
38. The staff asked several EITF Working Group participants what they would include in a negative definition, and two of those participants said that costs for training and business process reengineering would be examples of costs that are not implementation costs. These two participants explained that they consider implementation costs to be only those costs that would be capitalized under Subtopic 350-40 and, therefore, would not include training as implementation costs.
39. One accounting firm said that while there are probably differing views as to whether training and data migration are considered implementation costs, in either case these types of costs

should be expensed as incurred. Therefore, if there is a clear framework to determine what activities would and would not be eligible for capitalization, this firm would not see an issue with how implementation costs are explained in the Codification.

Staff Analysis and Recommendation

40. While the term *implementation cost* is not defined in the Codification, the term *implement* is used in the Codification with a common sense meaning (the process of putting something into place). For example, Subtopic 720-45 includes the phrase *implement internal-use software*.
41. Consistent with the feedback received, the staff believes that providing a prescriptive definition of the term in the Codification would be a challenge. A definition would need to be general enough to apply to all different types of CCAs and would need to stand the test of time.
42. During the outreach process, the staff determined that some participants consider the term *implementation cost* to include only those costs that would be capitalized under GAAP. Therefore, if including a negative definition, they would refer to training, business process reengineering or data conversion as not being an implementation cost.
43. However, the staff considers implementation costs to be those costs that occur during the implementation phase, consistent with the application development stage in Subtopic 350-40 and that the application development stage includes certain costs, such as training and data conversion, that are expensed as incurred.
44. Additionally, as noted above, Subtopic 720-45 states the following, and the context implies that business process reengineering costs (which are typically expensed as incurred) are indeed part of the process to “implement” the item:

The cost of business process reengineering activities, whether done internally or by third parties, is to be expensed as incurred. This expense treatment also applies when the business process reengineering activities are part of a project to acquire, develop, or **implement** internal-use software.
[emphasis added]

45. Based on the existing guidance, the staff believes that implementation costs would also include certain costs that would not be capitalized under either a CCA or a software license. Furthermore, including only costs that are capitalized as implementation costs could lead to confusion and diversity in how the phrase *implementation costs* is used depending on what alternative the Task Force chooses. That is because, depending on the Alternative chosen for Issue 3, there could be certain costs that would be capitalized for a software license, but would not be capitalized for a CCA. This could lead to the same costs that are considered implementation costs for a software license to not be considered implementation costs for a CCA.

46. In other words, the staff does not think that implementation costs should only be those costs that are capitalizable. The staff views implementation costs as those costs incurred to get the CCA ready for its intended use. Each of these implementation costs needs to be evaluated to determine whether, based on the guidance, they would be considered an asset or expensed as incurred, as further discussed in Issue 3.
47. The staff recommends that explanatory language be included in the guidance to provide examples of implementation costs. The staff would recommend that something similar to the language below be added to the Codification.

Implementation costs are internal or external costs that are incurred to bring the **hosting arrangement** [which is a defined term in the Codification] to the condition necessary for its intended use. Examples of these types of costs include, but are not limited to:

- (a) Integration (developing interfaces with entity's other systems)
- (b) Customization
- (c) Data conversion
- (d) Installation
- (e) Architecture and design
- (f) Coding
- (g) Testing
- (h) Training
- (i) Business process reengineering

Question for the Task Force

1. Does the Task Force want to include a definition of the term *implementation cost* within the Master Glossary of the Codification? If not, does the Task Force want to include examples of implementation costs in the Codification?

Scope of the Project (Issue 2)

48. Some stakeholders have questioned whether service arrangements that have a minor element of hosting or software as a service (where the main provision of the arrangement is something other than providing hosting or software as a service) would be in the scope of the amendments that result from this EITF Issue. An example is a manufacturing contract that includes a small component of hosting or software as a service for billing, logistics, and inventory management.
49. The definition of the term *hosting arrangement* in the Glossary is:

In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

Stakeholder Feedback

50. Most of the participants with whom the staff spoke did not have any concerns with including a scoping approach that refers to the hosting service as the predominant element in the arrangement. However, one accounting firm observed that this might lead to diversity because the predominance notion could be judgmental. However, that firm was ultimately not concerned with the approach suggested by the staff. Another practitioner questioned whether the term *predominant* is necessary because practice already applies the term *hosting arrangement* today.

Staff Analysis and Recommendation

51. As noted above, the term *hosting arrangement* is a Master Glossary term in Subtopic 350-40. Entities are already evaluating their hosting arrangements to determine whether they have a software license. Therefore, the staff does not think that entities would experience difficulties trying to understand the scope of this project as long as it is centered around the definition of hosting arrangements that are considered service contracts.
52. The staff is aware that the term *predominant* is not defined in GAAP and there could be inconsistencies as to what an entity considers to be predominant. However, there are several areas in the Codification that currently include this the term. Topic 230, Statement of Cash Flows, describes a *predominance principle* to determine whether cash flows that have characteristics of more than one category of classification (that is, operating, investing, or financing) should be bifurcated or, instead, classified based on the activity that is likely to be the “predominant” source or use of the cash flow item. This principle was recently revisited in Accounting Standards Update No. 2016-15, *Statement of Cash Flows (Topic 230), Classification of Certain Cash Received and Cash Payments*. More specifically, paragraph 230-10-45-22 says:

In situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use (for example, when a piece of equipment is acquired or produced by an entity to be rented to others for a period of time and then sold), the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item.

53. The staff also notes that there is a “predominance” concept in the implementation guidance of Topic 606. Paragraph 606-10-55-65A states:

The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

54. Finally, the staff notes that the term *predominant* is used in various other topics in the Codification and impacts accounting outcomes, such as Topic 815, Derivatives and Hedging; Topic 842, Leases; Subtopic 860-50, Transfers and Servicing— Servicing Assets and Liabilities; and Topic 970, Real Estate.
55. The staff understands that judgement will be required to determine when the CCA is the predominant element in the arrangement. However, considering the feedback received, the staff does not think that stakeholders will have difficulties in understanding how to apply the guidance. In addition, the staff thinks use of the term *predominant* will help stakeholders understand that the scope of the project does not include contracts in which hosting or software as a service is not the predominant element of the arrangement.
56. The staff considered whether additional scoping or unit of account guidance would be helpful, including the distinct notion in Topic 606 to determine whether the hosting arrangement is a separate element or combined within the arrangement. While the notion might be helpful to some entities in making judgments about scoping and unit of account questions, the staff thinks that introducing these concepts in the scoping literature of this narrow project would add complexity that might not be necessary and might not significantly reduce the need to use judgement anyway. Furthermore, the staff thinks that entities (customers) will continue to use judgement in determining the unit of account as they evaluate their contracts, because they are already doing so in current practice without prescriptive guidance. The staff thinks developing prescriptive unit of account guidance in this project might have unintended consequences because such guidance does not exist for customers for many other contracts.
57. The following is an example of language that the staff recommends be included in the amendments:

This guidance applies to a **hosting arrangement** (a) that is accounted for as a service contract in accordance with paragraph 350-40-15-4A and (b) for which hosting is the predominant element in this arrangement.

Question for the Task Force

2. Does the Task Force agree with the scoping approach developed by the staff?

Accounting for Implementation Costs Incurred in a CCA that is Considered a Service Contract (Issue 3)

58. As discussed in more detail in the Background Section, since Update 2015-05 was issued, the staff has received multiple requests to provide guidance on the accounting for implementation costs incurred in a CCA that is considered a service contract. Stakeholders explained that this

is an area with a lot of practice questions because there is no explicit guidance and CCAs are becoming more common.

59. Some questions that have been raised by stakeholders include:
- (a) If some of the implementation activities are for the creation of an asset (for example, software code), should those specific implementation costs be recognized as an asset even though the CCA is considered a service contract? How does one separate the costs in the arrangement between the portion that is for creating an asset and the portion that is not?
 - (b) How should an entity account for process redesign?
 - (c) How should an entity allocate the various implementation fees?
 - (d) Is there a difference in accounting for implementation activities depending on whether the entity engages the hosting provider to perform the implementation activities versus another third party (for example, a consulting firm)?
60. Some stakeholders have asserted that while the customer does not have control over the software license, they do have control over certain aspects of the arrangement including the data stored on the system, security access to the system, and configuring the system (for example, reports generated by the system). Therefore, stakeholders said that the accounting for the implementation costs should be consistent with an on-premise software license whether or not the arrangement is considered a service contract. Some stakeholders suggested an analogy for certain implementation costs to a leasehold improvement in accordance with Topic 842, Leases, because these are costs incurred to get the software ready to be used with the customer's systems and will provide a benefit to the entity in the future.
61. Some of the EITF Working Group participants supported capitalizing all, or most, implementation costs, while other participants supported applying aspects of existing GAAP (for example, guidance on software code, prepaid assets, property, plant, and equipment, business process reengineering). Some participants who support capitalization of implementation costs, did not support presenting those assets as a prepaid asset because they think the subsequent expensing of the assets should be presented in the income statement as an amortization expense. Also, some participants suggested creating an entirely new accounting model for these types of implementation costs (which would allow a path for capitalization as an intangible asset).
62. The staff was informed by some stakeholders that the statement of work for implementation activities sometimes is not always detailed enough to understand the exact nature of the costs. One preparer provided a statement of work to the staff, which included high-level steps that the vendor would take to implement the CCA. Therefore, if the entity was required to capitalize

only a portion of the implementation costs, it would need to obtain a better understanding of the work to allocate the total contract price to those items that should be recognized as an asset (or assess whether the amount the vendor says is related to those items is a reasonable allocation). The staff believes that most entities would have a good understanding of the work before signing a contract, although the accounting department might need to increase its understanding.

63. The staff originally presented Alternatives A and B (see below) to the Board at the agenda prioritization meeting in November 2016. At the May 2017 agenda prioritization Board meeting, the staff was directed to pursue the original two alternatives presented to the Board, as well as a third alternative whereby the accounting for implementation costs incurred in a CCA that is considered a service contract would be the same as the accounting for the implementation costs incurred when obtaining or developing an on-premise software license.

64. The following are alternatives for the Task Force to consider:

Alternative A—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Expense When Incurred.

Alternative B—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Asset or an Expense When Incurred on the Basis of Existing GAAP (Topic 340, Subtopic 350-40, Topic 360 Subtopic 720-45).

Alternative C—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Accounted for the Same as Implementation Costs Associated with a Software License.

Alternative C¹—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Accounted for Based on Topic 360.

65. Appendix A provides an illustrative example of the treatment of implementation costs incurred in a CCA that is considered a service contract under Alternatives A, B, C, and C¹.

Stakeholder Feedback

66. While some participants said that they are currently expensing all costs in a CCA that is considered a service contract because there is no explicit guidance, they were not in favor of Alternative A. Most stakeholders said that even though the accounting would generally be easier under Alternative A, they would prefer to separate the different components of the implementation costs and capitalize some of those costs. Some stakeholders noted that if Alternative A is pursued, it should be modified to require capitalization of long-lived assets (for example, servers).

67. Many stakeholders who are auditors said Alternative B is the most appropriate alternative. Those stakeholders explained that Alternative B is the closest alternative to what they are currently advising, it is conceptually sound, and it is consistent with Update 2015-05.
68. Those same stakeholders acknowledged the challenges with parsing the costs from the contracts into the different areas of current guidance, such as Subtopics 350-40 and 720-35, and Topics 340 and 360. In other words, it could be difficult for preparers to understand the nature of the activities and related costs. Although this is a potential difficulty, multiple stakeholders said that it would better reflect the economics of the transaction.
69. Some expressed concern that preparers may have difficulty applying a “distinct” notion to some of the implementation costs when determining whether they are distinct from the hosting because there are differing views on treatment of the costs depending on who is performing the implementation work as explained in the Background Section.
70. One accounting firm expressed concerns about different accounting outcomes under Alternative B depending on whether the work is performed by the hosting vendor, internally, or by a third-party consultant. In the view of that stakeholder, under Alternative B, if the work is performed internally or by a third-party consultant, the cost might be considered distinct from the hosting services, while the same cost might not be considered distinct if performed by the vendor of the hosting services. This might result in the cost incurred by the third-party consultant to be expensed as incurred, but the same cost would be considered a prepaid asset if incurred by the vendor of the hosting services.
71. That practitioner observed that if the distinct notion is utilized in the guidance, there should be some other principles around how all of the costs would be accounted for in the same way, regardless of who performs the work. This practitioner suggested that the staff consider language similar to the language included in paragraph 606-10-25-21(c) of Topic 606, which states:
- The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently
72. Additionally, stakeholders explained the challenge they face to determine which amortization period should be used for those costs that are not considered distinct and, therefore, are accounted for as a prepaid asset. This is discussed further in Issue 4.
73. Most preparers included in the staff’s outreach favored Alternative C. They assert that the implementation activities are the same regardless of whether or not the arrangement includes a software license. Therefore, they think the accounting for the costs should be identical.

Alternative C would align the accounting for implementation costs in a hosting arrangement with the accounting for implementation costs for a software license. They thought certain costs would be expensed under Alternative B that would be capitalized under Alternative C.

74. One key difference between Alternatives B and C that was raised by several stakeholders is the accounting for configuration costs. Under Alternative B, configuration of the vendor's software to enable the hosted software to meet the needs of the customer might be expensed as incurred, depending on whether the configuration is distinct from the hosting. However, under Alternatives C and C¹, these costs would be capitalized as a cost to get the asset ready for use.
75. Finally, two stakeholders observed that from their experience, some entities utilize the notion of *getting an asset ready for use* as described in Topic 360 when accounting for implementation costs of obtained (that is, not internally developed) software. Consequently, the staff identified Alternative C¹. One of those stakeholders said that the current guidance in Subtopic 350-40 is outdated and was written to accommodate technological transformations decades ago.

Advisory Committee Feedback

76. The staff met with the NAC and the PCC to obtain feedback on the prevalence of Issue 3. Both NAC and PCC members said that it is a prevalent and significant issue for not-for-profit organizations and private companies and that guidance would be helpful.
77. Most PCC members thought the accounting for implementation costs for a hosting arrangement should be the same as the accounting for implementation costs associated with a software license. Most PCC members also said that it would not be too costly for private preparers to track implementation costs, including internal labor hours and costs. One member expressed concerns from a conceptual perspective about how the implementation costs can be considered an asset if the underlying hosting arrangement is not considered a software license (asset). Another PCC member (lender) said that he would ignore an asset recognized for implementation costs because it is not an asset upon which the bank would lend. However, that PCC member noted that if material implementation costs are expensed in one period, it would be helpful to know that the expense is not recurring.

Question for the Task Force

3. Which accounting alternative does the Task Force want to select? Is there further research that the Task Force requests about the alternatives? If the Task Force selects Alternative B, does the Task Force want to provide guidance on how to allocate contract consideration to various elements in a contract?

Staff Analysis

Alternative A—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Expense When Incurred.

78. Under Alternative A, an entity would recognize implementation costs associated with a CCA that is considered a service contract (that is, hosting arrangements that do not meet the two criteria in paragraph 350-40-15-4A) as an expense when incurred. Therefore, both the hosting arrangement and its implementation costs would be accounted for similar to a service contract.
79. Proponents of Alternative A think that if the underlying cloud computing arrangement is not considered an asset, then the implementation costs associated with the arrangement should not be considered assets. They think there should be consistency in the accounting for the hosting service and the implementation of the hosting.
80. Proponents of Alternative A also assert this would be the least costly alternative, assuming there is not a significant amount of cost associated with determining whether a cost is for implementation activities or some other activities. This is because an entity (except in situations described in paragraph 83 of this memo) may not need to separately evaluate each component of the implementation costs, determine which of those costs are an asset and determine an amortization period for those assets.
81. Under Subtopic 720-45, the costs of business process reengineering activities, whether done internally or by third parties, are expensed as incurred. While Subtopic 720-45 explicitly does not apply to internal-use software or property, plant, and equipment, proponents of Alternative A would argue that implementation activities for cloud computing arrangements that do not include a software license are similar to business and technology reengineering and, therefore, expense treatment for these activities would be appropriate.
82. Opponents of Alternative A observed that this alternative would not be reflective of the economics of CCAs. These stakeholders said that under Alternative A, some costs would be expensed that would otherwise be recognized as an asset under other areas of GAAP. For example, assume that as part of its implementation of a new hosting arrangement, an entity engages a consulting firm to write software code to connect or bridge the entity's sales ledger with the hosting provider's off-premise customer relationship management system. The cost of writing the code would be recognized as software for internal-use under Subtopic 350-40 (although there is some diversity in practice, which is why this potential new project has been raised), absent GAAP requiring all implementation costs to be expensed under Alternative A.
83. Opponents of Alternative A also are concerned that there could be situations in which a customer acquires PP&E when implementing the CCA. Under Alternative A, they would have to expense all or part of the PP&E acquisition. For example, if an entity obtains computers in

order to access the CCA, Alternative A would require that the costs of the computers need to be expensed. This would be inconsistent with current GAAP, and the opponents argue that it is not representative of the economics. However, if the customer also utilizes the computer for other purposes beyond just access to the CCA, a possible application of Alternative A would be to separate the cost of the computer proportionately between the amounts to be expensed as CCA implementation and the amounts that would be capitalized under Topic 360. The staff believes that this could create complexity and may require further interpretive guidance.

84. Opponents of Alternative A further assert that some customer implementation activities would meet the definition of an asset in CON 6. Consider the example above that includes implementation activities to write software code. As addressed in more detail below under Alternative B, the staff believes that internal-use software meets the definition of an asset under CON 6. Furthermore, Section 350-40-25 requires that internal-use software be recognized as an asset. Therefore, Alternative A would result in different accounting for similarly viewed costs, which might lead to complexity for both preparers and users.
85. If the Task Force is interested in pursuing Alternative A, the staff could develop a modified alternative whereby certain implementation costs (for example, PP&E or software) would be capitalized in accordance with other GAAP. However, in the staff's view, if Alternative A were modified to require analysis of specific implementation costs, then the potential cost savings associated with Alternative A would be lost.

Alternative B—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Asset or an Expense When Incurred on the Basis of Existing GAAP (Topic 340, Subtopic 350-40, Topic 360, Subtopic 720-45).

86. Under Alternative B, implementation costs associated with a CCA that is considered a service contract would be recognized as an asset or an expense when incurred on the basis of existing guidance in Topic 340, Subtopic 350-40, Topic 360, and Subtopic 720-45. Alternative B would communicate how to apply that existing guidance on prepaid assets, software code, property, plant, and equipment, and business process reengineering to implementation costs for CCAs. Some of the guidance upon which Alternative B is built (that is, Topic 340, Subtopic 350-40, Topic 360 and Subtopic 720-45) has been applied in practice for an extended period and, so, many stakeholders are already familiar with the guidance. However, some of the guidance would be new, such as Topic 606 or Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers. In addition, not all of the guidance has been applied to CCAs.
87. The staff believes that a typical financial reporting outcome for implementation costs under Alternative B would be that an entity would recognize (if applicable):

- (a) Asset(s) for internal-use software
 - (b) Asset(s) for property, plant, and equipment (for example, computers, tablets, phones, servers)
 - (c) Asset(s) for prepayments to a cloud computing vendor for goods or services that are not distinct from the hosting services
 - (d) Asset(s) for prepayments to a consulting firm or other third-party service provider for services not yet performed
 - (e) Expense(s) for other implementation costs.
88. Alternative B would also clarify that when an entity makes a payment to its cloud computing provider for goods or services that are not distinct from the hosting service, the payment is a prepayment for cloud computing services (that is, the payment would be recognized as a prepaid asset). The notion of distinct goods or services would be the same as (or build on) the notion of distinct goods or services in Topic 606. This might be one of the most challenging aspects of Alternative B. The notion of distinct in Topic 606 requires the application of professional judgement, and at times significant professional judgement.
89. To demonstrate the application of the distinct notion to a CCA, consider the following example. An entity enters into a hosting arrangement for three years. Under the contract, the entity makes an upfront payment as well as monthly payments over the three years to the vendor. The contract states that the upfront payment is to compensate the vendor for configuring the vendor's cloud solution to meet the entity's needs.
90. Under Alternative B, the entity would need to decide whether the upfront payment should be capitalized or expensed as incurred. The upfront payment would not be capitalized as PP&E or software (intangible). Therefore, the key would be for the entity to consider whether the upfront payment should be capitalized as a prepaid asset.
91. To consider whether the upfront payment is a prepayment, the entity would assess whether the configuration activities are distinct from the hosting arrangement. This might not be a straightforward assessment for the entity, although the staff thinks that once preparers and auditors become familiar with the guidance that results from this project and practice develops (for example, implementation examples developed by the profession) the assessment might become more straightforward. When an entity is assessing whether the configuration activities are distinct from the hosting, the staff thinks it is possible an entity might (at least initially) conclude that the configuration services are not distinct from the hosting because the entity might assert that it would derive no benefit from the configuration without the hosting. However, the staff is aware that some cloud vendors consider some upfront activities to be separate deliverables under Topic 605 (because they have standalone value) and separate performance

obligations under Topic 606 (because they are distinct). It is this tension that leads the staff to conclude that accounting for prepayments is one of the most challenging aspects of Alternative B.

92. There are many different types of implementation costs and, therefore, the staff understands that an entity would need to make estimates and judgments to apply Alternative B. This is because under Alternative B an entity might need to separate various components of a single contract and allocate the consideration in the contract to those components. In addition, management estimates and judgments would be needed to account for internal costs (for example, payroll).
93. Under Alternative B, if costs are incurred for upgrades and enhancements, they would be capitalized if they result in additional functionality for the on-premise software. Those internal costs incurred for upgrades and enhancements would generally be accounted for in accordance with the accounting for application stage development costs as follows (the staff notes the concepts below generally apply to other broad implementation costs under Alternative B):
- (a) Prepayments for services that are not distinct from the hosting arrangement would be recognized as a prepaid asset in accordance with Topic 340. This would make the customer's accounting consistent with the vendor's accounting for the same arrangement.
 - (b) Internal and external costs incurred to develop or obtain internal-use software related to a hosting arrangement would be capitalized in accordance with Subtopic 350-40.
 - (c) Internal and external costs that involve business process reengineering activities would be expensed as incurred in accordance with Subtopic 720-45.
 - (d) Costs incurred for the acquisition of property, plant, and equipment related to a hosting arrangement would be capitalized in accordance with Topic 360.
 - (e) Other internal and external costs incurred that are not accounted for in accordance with the paragraphs above or other applicable guidance, shall be expensed as incurred.
94. Under Alternative B, an entity would need to allocate contract consideration (in some contracts) to various elements. For example, a contract might include activities and fees for hosting for three years as well as activities performed at the beginning of the arrangement that are distinct in some cases from the hosting, such as training, configuration of vendor's solution, and creating an interface between the vendor's solution and the customer's ERP. Several areas of GAAP have guidance for allocating contract consideration to different elements in a contract (for example, revenue, leases, and business combinations). Allocation of contract consideration sometimes is complex because of the wide range of arrangements (for example, consideration can be fixed, variable, or some combination; some elements can be optional purchases for the

customer and others required). Different areas of GAAP deal with some of those issues differently (for example, the guidance on variable consideration is intentionally different in Topic 606 and Topic 842 for lessors). The staff's current view is that the allocation guidance for a CCA in the scope of this project should be high-level and permit the use of significant judgement. The staff does not recommend that the Task Force mandate an allocation approach in other areas of GAAP (for example, Topic 606 or Topic 842).

95. Proponents of Alternative B observe that this alternative is consistent with what many preparers apply today and is grounded in principles that have been applied for many years. They also think Alternative B is conceptually consistent with the Board's decisions in Update 2015-05. In that Update, the Board decided when a CCA does and does not include an asset. They think the premise behind Alternatives A and C would be inconsistent with Update 2015-05.
96. Proponents acknowledge the concerns of opponents noted below (particularly about Alternative B being more complex and requiring more judgment than Alternatives A or C), but they think most of the concerns would be resolved by practice during the implementation phase of the project and would not be ongoing issues.
97. Opponents of Alternative B assert that this alternative is generally more complex and costly than Alternative A and possibly more complex than Alternative C. Alternative B is not an "option" to capitalize costs deemed implementation costs. Rather, it would be a requirement to bifurcate a contract or group of contracts, identify multiple elements, allocate the costs to each of the elements, and identify and apply the appropriate guidance for each element. The application of the guidance will range from straightforward (for example, property, plant, and equipment) to complex, depending on the arrangement and the element. Examples of complex application might include tracking internal costs for software development, evaluating whether payments to cloud vendors are for distinct goods or services based on guidance in Topic 606, determining an amortization period for prepaid assets (which might include a judgment about expected renewals, as is required in Subtopic 340-40 on costs to obtain a revenue contract), and allocating costs to each element.
98. Some opponents of Alternative B also observe that the financial reporting outcomes might vary depending on which party performs the implementation activities. An entity might conclude that some upfront services performed by the cloud computing vendor are not distinct from the ongoing hosting services performed by that same vendor. Therefore, the entity would recognize a prepaid asset for the costs paid that are not for distinct services, to reflect the fact that amounts were paid for services that will be provided at a future date. However, if the entity decides to engage another service provider (other than the cloud hosting vendor) to perform those implementation activities, the entity would recognize the costs as expenses as the services are performed.

99. While the staff understands the point raised by a few stakeholders, the staff generally thinks that if an entity can engage the cloud computing vendor or another party to perform identical services, the services are more likely to be distinct from the ongoing hosting services. If the services are distinct, then the financial reporting outcome would be the same (expense as incurred) regardless of whether the services are performed by the cloud computing vendor or another service provider. Alternative B is intended to be agnostic about the parties that perform the activities. In other words, the staff does not think the accounting outcome should vary on the basis of the party that performs the work. That said, the staff cannot dismiss the possibility of different financial reporting outcomes depending on which party performs the services. This is because determining whether a service is distinct sometimes requires significant judgment, and reasonable people can disagree. The possibility for different accounting outcomes for the same service depending on who performs the work could result in some conceptual concerns with Alternative B.
100. Opponents also observe that Alternative B has the potential to inadvertently change practice in a customer's accounting for other service contracts with vendors. In practice today, many customers do not identify multiple components of contracts with vendors, allocate the consideration to those components, and account for each component separately. Additionally, opponents think that while Alternative B could lead to greater precision in accounting for implementation costs, it would potentially increase costs for the preparer. The staff believes that it is possible that if Alternative B is pursued, preparers would analogize to this guidance when accounting for other contracts. The staff thinks the same concern is applicable to Alternatives A and C. See further discussion in the Issue 5 Section of this memo.
101. Finally, opponents of Alternative B express concerns about how an entity would separate the configuration or customization costs between the vendor's software and the customer's software. They observe that Alternative B would require an entity to analyze the contract to ascertain whether the configuration occurred on, and benefits, the vendor's or customer's system in order to determine whether to capitalize or expense the amount. Some have said that it may be difficult and costly to understand which system is receiving benefits from the configuration or customization.

Alternative C—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Considered the Same as Implementation Costs Associated with a Software License.

102. Under Alternative C, an entity would account for implementation costs incurred in a CCA in a manner consistent with implementation costs when a software license is acquired under Subtopic 350-40. Under Alternative C, an entity would expense those costs that are incurred in

the preliminary project and post-implementation-operation stages. Costs incurred for setup fees should be accounted for in accordance with guidance on prepaid assets in Topic 340, or other relevant guidance. Costs incurred for integration with on-premise software, coding, and configuration or customization are capitalized as intangible assets. Those costs incurred for data conversion and training are expensed as incurred. Any costs for business process reengineering would be accounted for in accordance with Subtopic 720-45.

103. For upgrades and enhancements, costs incurred would be capitalized if they resulted in additional functionality. Internal costs for upgrades and enhancements would be capitalized or expensed in accordance with the application development costs in the proposed paragraphs 350-60-25-2 through 350-40-25-6. Any maintenance costs should be expensed as incurred.
104. Proponents of Alternative C assert that the implementation costs for CCAs that are service contracts are economically similar to those incurred in an on-premise solution and, therefore, the accounting for implementation costs should be consistent. Proponents of Alternative C also explained that preparers do not have a difficult time using the guidance in Subtopic 350-40 for implementation costs for a software license. Therefore, they do not think it makes sense to create a new model, such as that under Alternative B, which may be more difficult for preparers to implement. These stakeholders preferred to treat the implementation costs the same even though that may result in capitalizing implementation costs related to an overall arrangement that is not an intangible asset.
105. Proponents of Alternative C supported extending the guidance that requires capitalization of direct and incremental costs necessary to get the software ready for the entity's intended use to CCAs that are accounted for as service contracts.
106. Opponents of Alternative C highlighted conceptual concerns with allowing for capitalization of costs in situations in which the entity does not have control of an asset. Based on the Board decisions made in Update 2015-05, those arrangements that do not meet both criteria in paragraph 350-40-15-4A are accounted for as service contracts and do not constitute a purchase of, or convey a license to, software. In other words, the FASB decided that the underlying arrangements (license or service contract) were not to be accounted for in the same manner. They were concerned the costs could be treated in the same manner because the underlying arrangement in a service contract is not an asset. Opponents also were concerned that Alternative C essentially unwinds the conceptual basis of Update 2015-05 and some stakeholders may eventually assert that the criteria and model introduced therein would need to be reevaluated to possibly allow for capitalization of the overall CCA as an intangible asset. Opponents of Alternative C also note that this model would be a significant change in practice for many preparers today who have CCAs that are service contracts, and who have sought to

apply the other GAAP described in Alternative B. They also think it would raise significant concerns about the accounting for other service contracts.

107. Opponents of Alternative C think that if the accounting for implementation costs was the same as the accounting for software on the basis that the arrangements are economically similar, then the accounting for the underlying arrangement (that is, the CCA) should be the same as the accounting for software. This would mean that the CCA would be recognized as an asset and that a corresponding liability for hosting fees paid over time also would be recognized. However, they note that approach would be inconsistent with the Board's decisions and basis in Update 2015-05.
108. Additionally, opponents of this Alternative said that the guidance in Subtopic 350-40 is outdated, and that the phases outlined in paragraphs 350-40-25-1 through 350-40-25-11 do not truly represent the current process of acquiring a software license. Some preparers asserted to the staff that Subtopic 350-40 can be difficult to apply today. Lastly, opponents assert that the boundary lines in the phases (preliminary project, application development, and post-implementation-operation) are not as structured in the context of a CCA that is a service contract and, if the Task Force were to choose Alternative C, revisions would likely need to be made to update the existing guidance to ensure the guidance would be suitable for CCAs that are considered service contracts.

Alternative C¹—Implementation Costs Associated with a CCA That Is Accounted for as a Service Contract Would Be Accounted for Based on Topic 360

109. To address some of the concerns of those participants who did not think that Subtopic 350-40 could be applied effectively to CCAs that are service contracts, the staff identified Alternative C¹. Under Alternative C¹, an entity would recognize implementation costs associated with a CCA that is considered a service contract using the concepts in Topic 360, Property, Plant, and Equipment. Therefore, the staff considered the following language in paragraph 360-10-30-1, when considering how Alternative C could be Codified:

Paragraph 835-20-05-1 states that the historical costs of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.

110. Proponents of Alternative C¹ observed that the guidance in Subtopic 350-40 is more applicable to developing internal-use software than obtaining a software license, and that some entities might be looking to other guidance, such as Topic 360, when determining what costs should be capitalized when obtaining a software license.
111. Opponents of Alternative C¹ observe that this would be potentially misleading because the implementation costs are not preparing an intangible asset to be ready for use and, therefore,

are not representative of the same transaction type. Furthermore, Topic 360 generally applies to physical items rather than intangible assets. Additionally, the staff notes that if C¹ were pursued, diversity in practice may persist because there is not detailed guidance within Topic 360 on the treatment of costs beyond the excerpt shown above. Therefore, if Alternative C¹ were chosen, opponents assert that the existing language above in Topic 360 would need to be clarified and enhanced in order for entities to apply Alternative C¹ to CCAs that are service contracts. Other opponent views of Alternative C¹ are similar to the opponent views described above for Alternative C.

Staff Recommendation

112. The staff recommends that the Task Force select Alternative B for the following primary reasons:
- (a) It is consistent with other areas of GAAP and is based on existing GAAP that has been applied for an extended period of time
 - (b) It is the most consistent with the framework around recognizing an asset under CON 6, and is most conceptually consistent with the amendments in Update 2015-05.
113. In making a recommendation, the staff considered the feedback of some stakeholders that Alternative B is more complex than Alternatives C and C¹. However, the staff thinks practice will be able to resolve most of the perceived complexity of Alternative B in the implementation phase. In addition, the staff thinks that Alternatives C and C¹ have their own complexities. Alternative C is based on guidance that was designed for different transactions than CCAs so their naturally will be some tension in applying the guidance to CCAs. Also, stakeholders say the guidance is outdated. Alternative C¹ involves adding limited guidance to the Codification. The staff suspects, based on the implementation questions received on some recently issued standards consisting of hundreds of pages of guidance, that practice would struggle with having only a single sentence to apply to CCAs. In addition, the staff thinks that the alternative would lead to diversity in practice, which would not be a good outcome for a project for which one of the objectives is to reduce diversity in practice.
114. While Alternatives B, C, and C¹ may ultimately result in similar accounting outcomes for many types of costs, the staff has concerns that Alternatives C or C¹ partially unwind an important conceptual distinction between software licenses and service contracts that was made in Update 2015-05, because these latter alternatives essentially indicate that the accounting for implementation costs should be the same regardless of the whether the criteria introduced in that Update are met.

Useful Life (Issue 4)

115. The staff considered what guidance, if any, should be provided on the useful life of the implementation costs that would be capitalized in a CCA that is considered a service contract. This would be a follow-on question that would arise if the Task Force selects Alternative B. There is already guidance on useful life for internal-use computer software and long-lived assets that would apply if Alternative C or C¹ were selected. Paragraphs 350-40-35-4 through 35-5 state:

In determining and periodically reassessing the estimated **useful life** over which the costs incurred for internal-use computer software will be amortized, entities shall consider the effects of all of the following:

- a. Obsolescence
- b. Technology
- c. Competition
- d. Other economic factors
- e. Rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware.

Given the history of rapid changes in technology, software often has had a relatively short useful life.

116. Under Alternative B, the existing guidance on useful life for internal-use software and long-lived assets would also be utilized to determine the useful life of those assets. Topic 340 does not provide detailed guidance on how to determine a prepaid asset's useful life. Paragraph 340-10-05-4 states:

Prepaid expenses are a category of assets that are typically used up or expire within the normal operating cycle of an entity. The term derives from the fact that they are paid in advance of their use or consumption.

117. For some prepaid assets in a CCA, recognition of the expense is straightforward. For example, if a customer in a CCA prepaid for training services, then it would recognize a prepaid asset and subsequently recognize an expense as the training services are performed by the vendor. However, for some prepaid assets in a CCA, the staff thinks stakeholders would have implementation questions about the period over which the expense should be recognized. For example, if the prepaid asset is for hosting services, should the expense be recognized over the legally enforceable contractual period, the enforceable period plus certain renewals, or some other period?
118. Therefore, the staff identified the following alternatives to estimate the useful life when existing guidance is not sufficient (that is, prepayments for hosting):

Alternative 1: Noncancelable hosting contract term plus expected³ renewal periods (expected period of benefit)

Alternative 2: Same guidance that entities use for costs to obtain a revenue contract in Subtopic 340-40 as seen below (provides guidance about the impact of optional renewals):

An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract.

Alternative 3: Noncancelable contract term (could be significantly shorter than expected period of benefit)

Alternative 4: Same guidance in paragraphs 350-40-35-4 through 35-5, as described above.

Stakeholder Feedback

119. Most of the outreach participants agreed there should be explicit guidance on the useful lives of those implementation costs that are capitalized in a CCA that is considered a service contract. Of those participants with whom the staff spoke, none preferred Alternative 3 (noncancelable contract term).
120. Of the participants who were in favor of Alternative B for Issue 3, the majority told the staff that the useful life should include expected renewals. They explained that most entities entering into a CCA do so with the intent of renewing the contract, especially in light of the significant costs to implement the arrangement. The participants who were proponents of Alternative C asserted that the existing guidance in Subtopic 350-40 was appropriate for those arrangements. The proponents of both Alternative C and C¹ agreed that the useful life should not be the contract term.
121. One accounting firm observed there would be differing amortization periods depending on whether the cost is considered a prepaid expense or an intangible asset. In their opinion, if the customer prepays implementation costs, then that prepaid asset would generally be amortized over the implementation period. However, if the customer prepays for a service that relates to the entire term of the agreement, or records an intangible asset relating to implementation costs (for instance, coding), those assets would be amortized over a longer period, such as the contract term plus renewals.

³ The Task Force might want to consider discussing when renewals would be accounted for; for instance, would renewals need to be expected, probable, or reasonably certain. However, this could possibly have broad implications beyond this narrow-scope project.

122. One of the outreach participants was a proponent of a principles-based approach, under which facts and circumstances would be considered and each entity would determine the expected period of benefit.

Question for the Task Force

4. If the Task Force selects Alternative B, does the Task Force want to provide guidance on useful life?

Staff Analysis and Recommendation

123. If Alternative B for Issue 3 is chosen by the Task Force, the staff thinks that the existing useful life guidance would be utilized for implementation costs that would be recognized as an asset on the basis of the existing GAAP. In other words, if PP&E or software code is recognized as an asset under existing GAAP, then an entity would apply the subsequent measurement in that existing guidance. However, if a prepaid asset is recognized for prepayments for hosting, then the staff recommends the expense be recognized over the expected period of benefit, which is the noncancelable hosting contract term plus expected renewal periods (Alternative 1).
124. The staff agrees with the outreach participants that using the contract term as the useful life would not be representative of the period over which the assets would provide benefit. The staff believes that using the concept of *expected period of benefit* is consistent with how preparers select depreciation and amortization periods for many other assets. It also is consistent with recently issued guidance in Subtopic 340-40 for incremental costs to obtain a contract with a customer. The staff does not think that adding extensive guidance is necessary or productive for this issue because judgement will be needed to estimate the amortization period anyway. Selecting amortization periods is inherently subjective and the staff does not think the guidance developed in this project should be more robust than the guidance for selecting an amortization period for other assets.
125. The staff believes that the useful life should be the same regardless of who is performing the work. While a third party is being hired to help with implementation, if that implementation is leading to the creation of an asset, then the costs should be amortized over the expected period of benefit.

Analogy to Other Service Contracts (Issue 5)

126. The staff is also considering whether the EITF should allow, prohibit, or remain silent on allowing the amendments resulting from this EITF issue to be analogized to other service contracts. The staff thinks this issue can be a question on any project, but because the topic

was raised by stakeholders several times, the staff thought it would be helpful for the Task Force to discuss the issue.

Stakeholder Feedback

127. While most of the outreach participants did not have any concerns with companies applying the guidance by analogy to other types of service contracts, most preferred that the EITF remain silent on the issue. One participant observed that CCAs are so unique that it would be difficult to appropriately analogize these potential amendments to other service contracts depending on the accounting alternative selected.
128. Another stakeholder indicated that he did not expect that these amendments would have an unintentionally broad effect on other service contracts. He explained that a CCA is different from other types of service contracts in that a CCA is generally replacing an on-premise software license that was accounted for as an intangible asset. Whereas, other service contracts are typically outsourcing a function that would have been accounted for as an expense prior to being outsourced.
129. One accounting firm suggested that the Task Force should prohibit analogizing, unless the Board takes on a project to account for implementation costs incurred in all executory contracts.

Question for the Task Force

5. Does the Task Force have any input about applying the guidance by analogy to other types of service contracts?

Staff Analysis and Recommendation

130. The staff agrees with the feedback received from most participants that if Alternative B is selected, the Task Force should remain silent on whether the guidance could be applied by analogy to other service contracts that are not within the scope of the project. The staff recognizes that there may be some circumstances in the future that would call for an appropriate analogy to this guidance and, therefore, the staff would not want to preclude analogy. However, the staff acknowledges that there is a potential for analogizing to be problematic if Alternatives A, C, or C¹ are chosen. Nevertheless, the staff believes that preparers and auditors can make appropriate judgments about applying guidance by analogy in the absence of explicit guidance.

Next Steps

131. Based on the decisions reached by the Task Force on the above issues, the staff will perform additional research and outreach to develop draft implementation guidance based on the accounting alternative selected for Issue 3. The staff plans to continue discussion on this

project at the September 2017 EITF meeting and present any findings of additional research, as well as discuss implementation guidance, transition, and disclosure considerations.

APPENDIX A

This example illustrates how an entity might apply the guidance under Alternative A, Alternative B, and Alternative C, to particular aspects of the implementation costs incurred when acquiring a CCA on the basis of the limited facts presented.

Facts

Customer engages Vendor to provide hosting services as part of a CCA that does not include a software license in accordance with paragraph 350-40-15-4A. The arrangement will provide Customer with a customer relationship management database solution that will provide real-time customer information from various internal systems. The components of this arrangement include (1) creation of interfaces between the database and source systems; (2) coding and customizing the Customer's on-premise licensed software to meet the needs of Customer; and (3) hosting services.

The hosting arrangement is for a term of five years with renewal options.

The costs expected to be incurred by Customer (vendor, internal, and third-party consulting costs) include:

- Preliminary project stage costs
 - Conceptual formulation of alternatives, evaluation of alternatives, determination of existence of needed technology, final selection of alternatives, selection of vendor
- Application development costs
 - Internal and external costs incurred to integrate the software that a customer obtains access to in a hosting arrangement that is considered a service contract with the customer's internal-use computer software
 - Data conversion costs
 - reconciling new data with the data extracted from an old system
 - purging existing data
 - creating or inputting new data
 - Installation of hardware
 - Architecture and design costs (configuration of vendor's and customer's software, financial data modeling)
 - Coding costs (vendor's and customer's software)
 - Testing costs
 - Training costs, including parallel phases
 - Travel expenses incurred by employees
 - Business process reengineering
- Post implementation-operation stage costs
 - Internal and external training costs
 - Ongoing maintenance costs
- Upgrades and enhancements to the vendor's or customer's software to make modifications or to add functionality

Staff note: The following table should not be considered an interpretation of current GAAP. This table is intended for illustrative purposes to facilitate the EITF's consideration of the different accounting alternatives to be discussed at the July 20, 2017 EITF meeting.

Type of Implementation Cost	Alternative A	Alternative B	Alternative C*
Preliminary project stage	Expense as incurred	Expense as incurred	Expense as incurred
Application development stage	Expense as incurred	<u>Integration with on-premise software</u> – capitalize, if it benefits on-premise software	<u>Integration with on-premise software**</u> – capitalize
		<u>Installation of hardware</u> – capitalize in accordance with Topic 360	<u>Installation of hardware</u> – capitalize in accordance with Topic 360

		<u>Coding</u> – capitalize if it benefits on-premise software. Expense if it is vendor's software (unless it is not distinct from hosting)	<u>Coding</u> * – capitalize
		<u>Configuration / customization</u> (Customer's system) – capitalize, if it benefits on-premise software	<u>Configuration / customization</u> * (Customer's system) – capitalize
		<u>Configuration / customization</u> (Vendor's system) – expense if distinct from hosting; prepaid if not distinct from hosting.	<u>Configuration / customization</u> * (Vendor's system) – probably capitalize
		<u>Travel expenses</u> – expense as incurred	<u>Travel expenses</u> * - capitalize
		<u>Data conversion</u> – generally expense as incurred (Capitalize if developing software to do conversion)	<u>Data conversion</u> – generally expense as incurred (Capitalize if developing software to do conversion)
		<u>Training</u> – expense as incurred	<u>Training</u> – expense as incurred
		<u>Business process reengineering</u> – expense as incurred in accordance with Subtopic 720-45	<u>Business process reengineering</u> – expense as incurred in accordance with Subtopic 720-45
Post-implementation-operation stage	Expense as incurred	Expense as incurred	Expense as incurred
Upgrades and Enhancements	Expense as incurred	<u>Specified upgrades and enhancements</u> – capitalize if it results in additional functionality to on-premise software, otherwise expense	<u>Specified upgrades and enhancements</u> – capitalize if it results in additional functionality
		<u>Internal costs for upgrades and enhancements</u> - capitalize or expense internal costs in accordance with the accounting for the application stage development costs in proposed paragraphs 350-60-25-2 through 350-40-25-6	<u>Internal costs for upgrades and enhancements</u> - capitalize or expense internal costs in accordance with the accounting for the application stage development costs in proposed paragraphs 350-60-25-2 through 350-40-25-6
		<u>Maintenance</u> – expense as incurred	<u>Maintenance</u> – expense as incurred

* Under Alternative C¹ the customer would capitalize the implementation costs of acquiring a software arrangement. This includes the costs necessarily incurred to bring it to the condition necessary for its intended use. The staff expects that the outcomes from Alternative C¹ would be similar to outcomes reached under Alternative C in most cases.

** These are illustrative examples of “internal and external costs to develop or obtain internal-use computer software during the application development stage,” which is the language utilized in paragraph 350-40-25-2.