Cloud computing arrangement costs - Updated

Reporting Update

24 May 2021, 21RU-005

Highlights

In a nutshell …

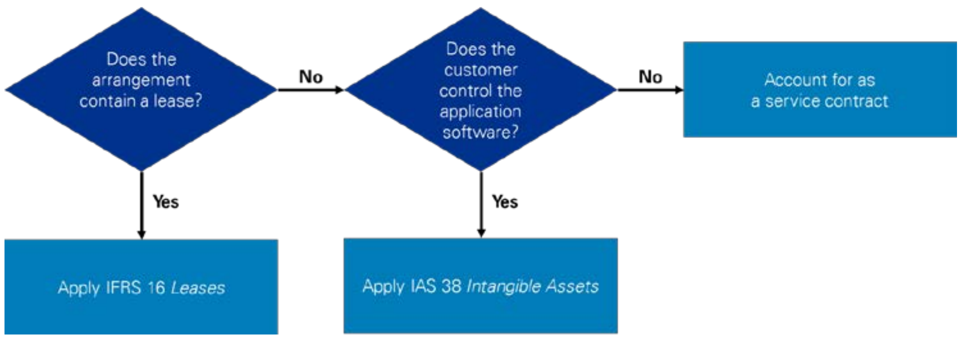
Right of access

Cloud computing arrangements are ones in which a customer does not have possession of the underlying software. Rather, the customer accesses and uses the software on an as-needed basis – for example, over the internet. Cloud computing arrangements are sometimes referred to Software as a Service (SaaS), infrastructure as a service or hosting arrangements.

To date, IFRS® Standards do not contain explicit guidance on a customer's accounting for cloud computing arrangements or the costs to implement them.

Judgement required

An entity should evaluate whether the rights granted in a cloud computing arrangement are within the scope of IAS 38 *Intangible Assets* or IFRS 16 *Leases*. Otherwise, the arrangement is likely to be a service contract.



IFRIC discussion

IFRS® Interpretations Committee (IFRIC) has issued two final agenda decisions on cloud computing arrangements. The March 2019 decision considers whether a customer receives a software asset at the contract commencement date or a service over the contract term. The April 2021 decision builds on the 2019 decision and considers how a customer accounts for configuration or customisation costs where an intangible asset is not recognised. Both are discussed in this publication.

Accounting for costs

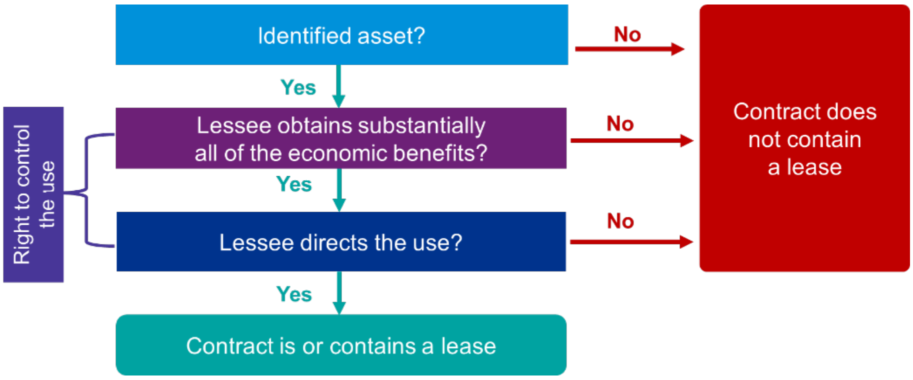
This update discusses how an entity which incurs cloud computing arrangement costs, including implementation costs, may account for those costs – i.e. capitalise or expense.

Contains a lease?

IFRS 16 sets out the definition of a lease and a key element is that the contract must convey a right to use an asset. It further explains that the right to use an asset, throughout the period of use, is where a customer has both:

- the right to obtain **substantially all the economic benefits** from use of the identified asset
- the **right to direct the use** of that asset – for example, decision-making rights to change the asset and for what purpose the asset is used.

Lease definition



IFRIC issued a final agenda decision in March 2019 which discussed SaaS arrangements. IFRIC observed:

How and for what purpose

> "that a right to receive future access to the supplier's software running on the supplier's cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used – the supplier would have those rights by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run. Accordingly, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the contract does not contain a software lease."

Generally, arrangements not a lease

In our experience cloud computing arrangements generally do not meet the definition of a lease under IFRS 16. This is because a right to receive future access to the supplier's software does not in itself give the entity any decision-making rights about how and for what purposes the software is used.

If a cloud computing arrangement does contain a lease an entity may apply the provisions of IFRS 16. Refer to KPMG's *Insights into IFRS* (Chapter 5.1) for further detail.

Tangible assets in same contract

An entity should evaluate whether a cloud computing arrangement includes a right to use **tangible** asset(s) – for example, servers. If this is the case the lease of the tangible asset(s) will be accounted for separately under IFRS 16.

Contains an intangible asset?

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance.

Identifiable

In order for an intangible asset to be recognised it needs to be 'identifiable'. An item is identifiable if it is separable (capable of being divided from the entity) or arises from contractual or other legal rights.

Control is key

In addition, an entity must control the intangible asset. IAS 38.13 specifies that an entity controls an intangible asset if it has power to obtain future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.

In relation to cloud computing arrangements an entity will need to assess whether an intangible asset(s) is/are present, i.e. does the contract provide the customer with a resource that it can **control**. In the IFRIC final agenda decision in March 2019 they observed:

Future economic benefits – restrict others' access to

> "that, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the customer does not receive a software intangible asset at the contract commencement date. A right to receive future access to the supplier's software does not, at the contract commencement date, give the customer the power to obtain the future economic benefits flowing from the software itself and to restrict others' access to those benefits."

Not an intangible asset

In our experience, cloud computing arrangements usually do not give rise to an intangible asset under IAS 38. This is because a right to receive future access to the supplier's software does not in itself give the entity the power to obtain the future economic benefits flowing from the software and to restrict others' access to those benefits.

However, in some limited circumstances an entity may determine that it controls a software intangible asset. In our view, features of a cloud computing arrangement that may indicate that the entity obtains control of a software intangible asset include:

Features which may indicate control

- the right to take possession of the software and run it on the entity's own or a third party's computer infrastructure, or
- exclusive rights to use the software or ownership of the intellectual property for customised software – i.e. the vendor cannot make the software available to other customers.

Service contract if no control

If the cloud computing arrangement does not provide the customer with an intangible asset for the software, and does not contain a lease, then the right to access the software over the contract term in the future is a service contract.

Executory contract – recognised when received

If an entity determines that a cloud computing arrangement is a service contract, then it recognises the related expenditure when it receives the service. This is explored further on the next section of this update.

If an entity pays for this service in advance, then it recognises a prepayment asset. Conversely, an entity recognises an accrued expense if it receives a service in advance of paying for that service.

Intangible asset present – treatment of costs

Intangible asset is present

For a cloud computing arrangement that is **not a lease** but where the cloud application software (**intangible asset**) is identifiable and is controlled by the customer the following summarises how to account for the various costs that might be incurred in establishing a new arrangement. For example, an on-premise software licence arrangement where the customer licences or purchases a copy of the software and operates the software on its own computing infrastructure.

When an entity acquires a software intangible asset, the cost of the asset includes the directly attributable costs of preparing the software for its intended use.

Common implementation costs

In addition to a fee for use of the software application, commonly entities will contract with the software supplier or third parties to provide implementation activities and other services – for example:

- data conversion and migration costs
- configuration costs (involves changing the default settings of the vendor's software to function in a particular way – for example, setting flags, or defining values or parameters)
- customisation costs (involves modifying the vendor's existing code or writing new code to change or create additional functionalities)
- interfacing costs (creation of new interface between an entity's existing software and the new software)
- testing costs
- training costs.

Allocate costs to different elements

An entity will be required to allocate amounts (for example, using relative standalone arm's length price) paid/payable across the fee for use and the various implementation and other services.

Generally expected treatment

Type of payment	Includes an intangible asset
Fee for use of software application	Capitalise under IAS 38[1]
Hardware costs	Generally capitalise under IAS 16 requirements
Research costs	Expensed as incurred under IAS 38.54
Configuration/customisation costs	Generally directly attributable, capitalise under IAS 38
Changes to existing systems (including interfacing costs)	Generally capitalise under IAS 38 requirements[2]
Data conversion and migration costs	Conversion software capitalise under IAS 38 requirements Other costs[3] should be expensed as incurred
Testing costs	Generally directly attributable, capitalise under IAS 38
Training costs	Expensed as incurred under IAS 38.69

Notes – see over

Notes

1 Cost includes purchase price, including non-refundable duties and taxes, trade rebates/discounts and any other directly attributable costs of preparing the asset for its intended use. Refer to KPMG's *Insights into IFRS* (3.3.100) for further detail and summary contained below ('Types of costs to capitalise').

2 Modified/enhanced system must continue to be used in conjunction with the cloud computing arrangement, for example changes that integrate existing systems into the cloud computing arrangement. In addition, the enhancement must result in increased functionality – otherwise the costs would be expensed as maintenance costs.

3 Other costs, outside the costs to obtain or develop data conversion software, incurred during the data conversion process should be expensed as incurred. These costs do not create a separate asset under IAS 38 – i.e. the identifiability criteria would not be met. Examples of other costs include reconciling extracted data, purging existing data, inputting new data.

The above information is included for completeness purposes. In our experience, cloud computing arrangements usually do not give rise to an intangible asset – for reasons included in the March 2019 IFRIC agenda decision as discussed earlier.

Service contract

Allocate costs to different elements

Generally expected treatment

Is a service contract - treatment of costs (not involving a lease or intangible asset)

For a cloud computing arrangement that is not a lease and where the cloud application software is not controlled by the customer the following summarises how to account for the various costs that might be incurred in establishing a new arrangement.

In addition to a fee for use of the software application, commonly entities will contract with the software supplier or third parties to provide implementation activities and other services. The definitions of the 'types of payment' used in the table below are those outlined on page 4 of this Reporting Update.

An entity will be required to allocate amounts (for example, using relative standalone arm's length price) paid/payable across the fee for use and the various implementation and other services.

Type of payment	No intangible asset
Fee for use of software application	Expense as the service is provided
Hardware costs	Generally capitalise under IAS 16 requirements[1]
Research costs	Expensed as incurred under IAS 38.54
Configuration/customisation costs	Refer to 'IFRIC and configuration or customisation costs' discussion below
Changes to existing systems (including interfacing costs)	Generally capitalise under IAS 38 requirements[2]
Data conversion and migration costs	Conversion software capitalise under IAS 38 requirements Other costs[3] should be expensed as incurred
Testing costs	Generally expensed as incurred under IAS 38[4]
Training costs	Expensed as incurred under IAS 38.69

Notes

1. If the hardware which stores the cloud application software is owned (controlled) by the customer, you should re-think if the customer has control of the cloud application software in accordance with the guidance in the March 2019 IFRIC agenda decision.

2. Modified/enhanced system must continue to be used in conjunction with the cloud computing arrangement, for example changes that integrate existing systems into the cloud computing arrangement. In addition, the enhancement must result in increased functionality – otherwise the costs would be expensed as maintenance costs.

3 Other costs, outside the costs to obtain or develop data conversion software, incurred during the data conversion process should be expensed as incurred. These costs do not create a separate asset under IAS 38 – i.e. the identifiability criteria would not be met. Examples of other costs include reconciling extracted data, purging existing data, inputting new data.

4 A cloud computing arrangement that is a service contract does not itself include a software intangible asset and the costs of preparing that software for use do not create a separate resource controlled by the entity. As such the costs need to be expensed as the customer receives the testing service.

IFRIC and configuration or customisation costs

IFRIC April 2021 agenda decision

The April 2021 decision considers how a customer accounts for configuration or customisation costs where an intangible asset is not recognised.

In the fact pattern presented the **supplier (not customer) controls** the cloud application software to which the customer has access. As such any configuration or customisation costs incurred by the customer do not create a resource controlled by the customer that is separate from the software.

IAS 38 – expense when service is received, not when used to deliver another service

Where these costs do not create a resource controlled by the customer that is separate to the software, the customer considers IAS 38.69 which requires the customer to recognise configuration or customisation costs as an expense when it **receives** the configuration or customisation services. IAS 38.69A specifies that **services are received** when they are performed by a supplier in accordance with a contract to deliver them to the entity – and not when the entity uses them to deliver another service. So, for configuration and customisation services received – the costs are expensed as the service is received and not when the customer accesses the SaaS arrangement to which the configuration and customisation services relates.

IFRIC guidance on identification (not included in IAS 38)

IAS 38, however, does **not** include requirements that deal with the **identification of the services** the customer receives to determine when the supplier performs those services per the contract. IFRIC has provided guidance in relation to the identification of services the customer receives in relation to configuration or customisation costs.

IFRIC observed – follow principles in IFRS 15

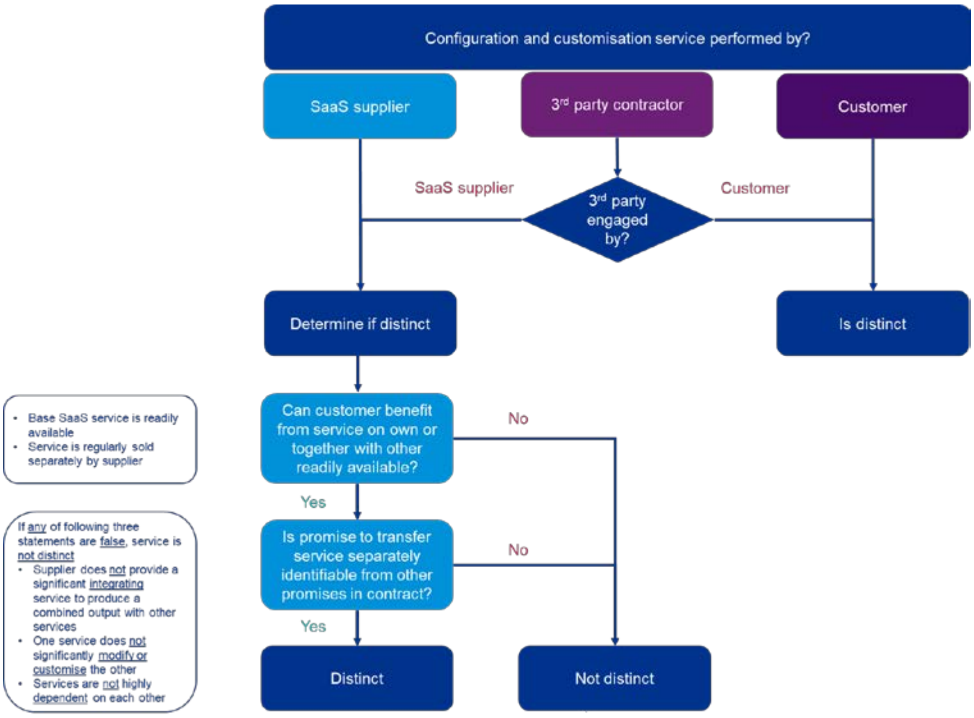
In the IFRIC final agenda decision in April 2021 they observed:

> "IAS 38 includes no requirements that deal with the identification of the services the customer receives in determining when the supplier performs those services in accordance with the contract to deliver them. Paragraphs 10–11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* require the customer to refer to, and consider the applicability of, the requirements in IFRS Standards that deal with similar and related issues. The Committee observed that IFRS 15 *Revenue from Contracts with Customers* includes requirements that suppliers apply in identifying the promised goods or services in a contract with a customer. For the fact pattern described in the request, those requirements in IFRS 15 deal with issues similar and related to those faced by the customer in determining when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services."

How to apply the IFRS 15 guidance?

In order to assist in practically applying this decision for customisation or configuration expenditure we have developed the following decision tree.

Application decision tree



For fact patterns where the **supplier** of the application software (or a **third party engaged by the supplier**) also provides the configuration or customisation services the customer applies paragraphs 69–69A of IAS 38 and determines when the supplier of the application software performs those services in accordance with the contract to deliver them as follows:

Distinct

- if the services the customer receives are **distinct**, then the customer recognises the costs as an expense when the supplier configures or customises the application software – which **will not be over the SaaS contract term**.

Not distinct

- if the services the customer receives are **not distinct** (because those services are not separately identifiable from the customer's right to receive access to the supplier's application software), then the customer recognises the costs as an expense when the supplier provides access to the application software **over the SaaS contract term**.

For fact patterns where a **third party supplier** (**engaged by the customer**) provides the configuration or customisation services – the customer applies IAS 38.69-.69A as follows:

- it determines when those services are performed in accordance with the third party supplier contract to deliver them
- the configuration or customisation costs are recognised as an expense when the third party supplier configures or customises the application software.

Prepayment

If the customer pays the supplier before receiving the services, it recognises the prepayment as an asset in accordance with IAS 38.70.

Distinct or not distinct?

As can be seen from the above decision tree assessing if an expenditure is distinct or not distinct is the most technically involved part of the decision tree.

Contracts may contain promises to deliver to a customer more than one good or service. At contract inception, an entity evaluates the promised goods or services to determine which goods or services are distinct. The guidance in IFRS 15 includes two criteria:

- capable of being distinct
- distinct within the context of the contract.

If either test is 'failed' then the promised good or service is not distinct.

Criteria 1

Capable of being distinct

The first criteria considers whether a customer can benefit from the service on its own or together with other readily available resources. If so, then it may be distinct – depending on the outcome of the second criteria.

In making this assessment we would consider the base cloud application as a resource that is readily available.

Criteria 2

Distinct within the context of the contract

Here the focus is on whether the suppliers promise to transfer a good or service is separately identifiable from other promises. IFRS 15 provides three indicators to help evaluate this issue – which are outlined in the above decision tree.

Customisation

Let's focus on the middle one as this will likely be the key one for the assessment in cloud computing fact patterns – for service to be **distinct** it should **not significantly modify or customise** another good or service in the contract.

In the context of cloud computing arrangements, if the **customisation** service requires the supplier to **significantly modify** the software, then a customer might conclude that the promises to transfer the software and the customisation service are **NOT distinct** within the context of the contract.

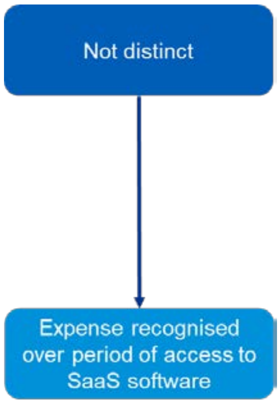
Configuration

However, the conclusion could be different in a case when a supplier provides **configuration** services which are not likely to significantly modify the software. So, the IFRS 15 guidance should be carefully analysed by organisations in each particular scenario.

What is the accounting if expenditure is either distinct or not distinct?

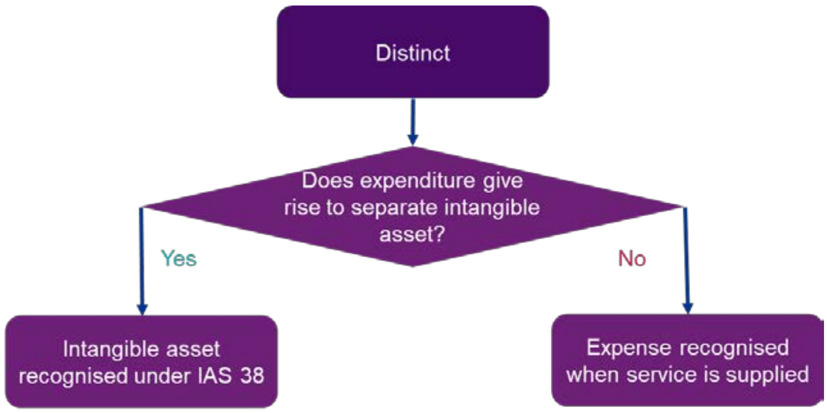
Not distinct configuration and customisation costs

Expense over period of access to SaaS software



If not distinct the configuration or customisation expenditure will be expensed over the period the customer has access to the application software.

Distinct configuration and customisation costs



Does IAS 38 apply?

If distinct we first should ask if the expenditure gives rise to a **separate intangible asset**. For example, a customer writes code to bridge/transfer data from its existing (owned) payroll system to the SaaS general ledger system. The code is owned by the customer – that is the expenditure will meet the identifiability and control criteria in IAS 38 (as discussed above). So this expenditure qualifies as a separate intangible asset.

Yes

If the expenditure **does give rise to an intangible asset**, then it should be accounted for under the requirements of IAS 38 – capitalise and amortise.

No

If the expenditure **does not give rise to an intangible asset**, then it will be expensed at a point in time when the configuration or customisation service is supplied/received – which will be a shorter timeframe than the period of time the customer has access to the application software.

If the customer pays the supplier before receiving the services, it recognises the prepayment as an asset. The asset is expensed when the service is supplied.

"Implementation costs related to a cloud computing arrangement that is a service are often significant.

When the cloud supplier agrees to customise the software by modifying the existing software code or writing new code, we believe that this customisation service is generally not distinct from the service of receiving access to the software – i.e. the service in the contract is access to the customised software application. Therefore, the expense should be recognised as the customer receives access to the customised software – i.e. over the SaaS contract term.

A cloud computing arrangement that is a service contract does not itself include a software intangible asset and the costs of preparing that software for use do not create a separate resource controlled by the entity. Therefore, these costs are not capitalised as part of the cost of a software intangible asset but are expensed as incurred, i.e. when the service is received. In our view, this generally applies to costs incurred for configuring the software – i.e. they are generally considered to be distinct. These costs should be expensed when they are incurred – i.e. when the service is received."

Michael Voogt
Director

Impact of IFRIC agenda decision on prior period accounting?

Must be adopted

IFRIC agenda decisions are a way of making a statement about why a change of an existing IFRS requirement or an interpretation of that requirement is not necessary. As a result, final agenda decisions form part of IFRS® guidance. They must be followed in order to claim IFRS® compliance.

Adopted retrospectively

Remember any changes resulting from agenda decisions would be accounted for as a change in accounting policy in accordance with IAS 8, i.e. it is to be applied retrospectively. Appropriate disclosures of the change are required by IAS 8.

Adopted in a timely manner

The IASB® Board (Board) expects entities to implement accounting policy changes in a timely manner if their policies are inconsistent with an agenda decision. The Board is now formally involved in the finalisation of agenda decisions. Agenda decisions cannot add or change requirements in IFRS Standards, but rather aim to improve consistency in their application.

If you are unable to adopt the April 2021 agenda decision before you finalise your next financial statements (say because of the complexity and volume of costs incurred) please engage in discussion with your auditors.

Disclosure

Entities delaying the implementation of the agenda decision should include disclosure in their financial statements about the implications of the IFRIC agenda decision.

Types of costs to capitalise

Research phase

Expense

All costs incurred during the research phase is required by IAS 38 to be recognised as an expense when it is incurred.

Development phase

Some may be capitalised

Costs that are capitalisable under IAS 38 include external direct costs of materials and services used to develop an asset, payroll and associated on-costs for employees who are directly involved with the development of the asset and depreciation/amortisation of assets used directly to develop the underlying asset.

Borrowing costs that meet the requirements of IAS 23 *Borrowing Costs* – asset takes a substantial period of time to get ready for its intended use – can be included as an element of cost.

Indirect costs and general overheads cannot be recognised as part of the cost of an intangible asset – even if they can be allocated on a reasonable and consistent basis.

Cost capitalisation to develop an intangible asset should stop when the asset is substantially complete and ready for its intended use.

Training activity costs should be expensed as incurred in accordance with IAS 38.69.

"For many cloud computing arrangements, the implementation activities can be complicated so judgement will be required to determine the split of amounts paid/payable into their respective elements. Appropriate records will be required to be maintained, including segregating employee time.

Where the cloud computing supplier also supplies implementation services it may be difficult to identify and allocate consideration to each component.

Each element that meets the definition of an intangible asset should be accounted for under IAS 38. Elements outside the scope of IAS 38 should be accounted for based on other IFRS® Standards – for example, computer hardware acquired as part of the arrangement will generally be capitalisable under IAS 16 Property, Plant & Equipment."

Michael Voogt
Director