Cloud computing implementation costs

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What's the issue?

Implementation costs in cloud computing arrangements can be significant – companies need to determine whether these costs should be **expensed as incurred** or **capitalised**. The IFRS Interpretations Committee's (the Committee) March 2021 decision clarifies how to perform this analysis for implementation costs incurred in a **cloud service contract** – i.e. when the customer does not control a software intangible asset.

What's the impact?

The decision clarifies that in a **cloud service contract** the customer needs to assess whether the implementation service is **distinct** from the service of receiving access to the software. As such, some companies may need to change their current accounting policy and could also see an impact in their income statement as many implementation costs for cloud service contracts will need to be **expensed as incurred**.

What's next?

This guide gives our insight and analysis, including a framework that helps companies apply the Committee's decision. Using this framework, assess your current accounting policy and determine whether any implementation costs incurred should be expensed or capitalised.

KPMG

What is cloud computing?

In a **cloud computing arrangement**, a customer pays a fee to a vendor in exchange for access to software over the internet.

The software is **hosted by the vendor on the vendor's computing infrastructure**[1].

Customers in cloud computing arrangements often incur up-front **costs to implement the software**.

The accounting for these **implementation costs** depends on whether the customer has a **software asset or a service contract.**

Examples of implementation costs

- Testing
- Data migration and conversion
- Training[2]
- Configuration of the software
- Customisation of the software

[1] This differs from an 'on-premise' arrangement where a company licenses or purchases a copy of the software from a vendor and operates the software on its own computing infrastructure.
[2] Training costs need to be expensed in accordance with paragraph 69 of IAS 38.

Cloud computing - Software asset or service contract?

To determine whether it has a **software intangible asset or a service contract**, a company assesses whether it **controls** the software.

This drives the accounting for the related **implementation costs**.

In our experience, cloud computing arrangements usually do not give rise to a software intangible asset under IAS 38.

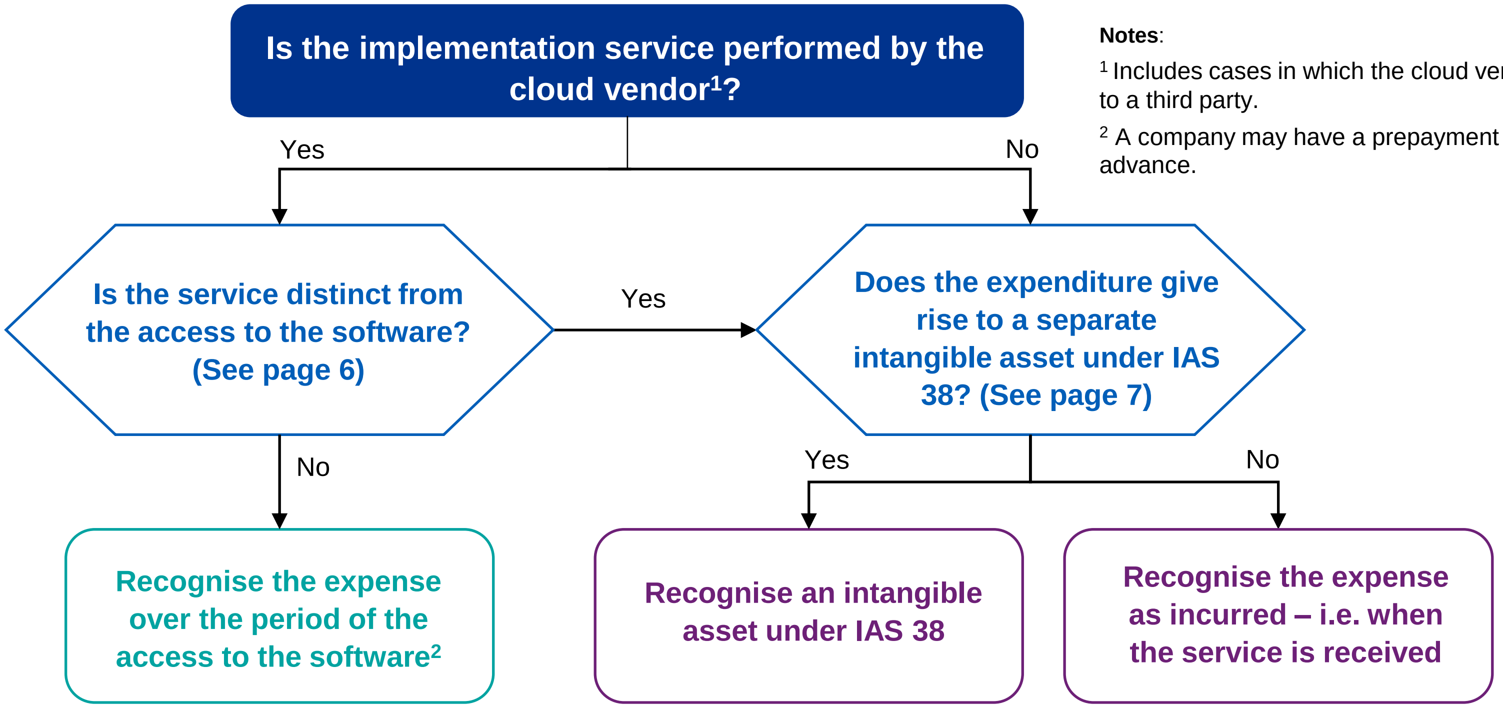
Does the customer control the software?

- **Yes** → **Software intangible asset** → **Apply IAS 38 *Intangible Assets*** Capitalise the directly attributable implementation costs of preparing the software for its intended use.
- **No** → **Service contract** → **Apply the framework** on page 5 which is based on IFRIC's March 2021 agenda decision[1] to account for implementation costs.

[1] *Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets)*

Implementation costs for a service contract

The Committee's March 2021 agenda decision addressed the accounting for configuration and customisation costs in a cloud service contract. The following framework is based on the principles in that decision and helps companies determine how to account for **implementation costs** in a cloud **service contract**.



Notes:

[1] Includes cases in which the cloud vendor subcontracts services to a third party.

[2] A company may have a prepayment asset if it is paid in advance.

Applying the framework - Is the service distinct?

Is the service distinct from the access to the software – e.g. could it be performed by a company other than the cloud vendor?

If the cloud vendor performs the implementation service, then the customer assesses whether that service forms part of the service of receiving access to the software or is distinct. It does this by applying the principles in *IFRS 15 Revenue from Contracts with Customers*.

This assessment is not necessary for services performed internally or by a third party other than the cloud vendor because those services are distinct from the service of receiving access to the software provided by the cloud vendor.

Distinct

If the cloud vendor performs the implementation service, but another company – e.g. a consulting company – would be *capable* of performing the service without also providing the access to the software, then the implementation service is generally distinct from the service of receiving access to the software. This is because in this case, the cloud vendor's implementation service is not integral to the customer's ability to derive its intended benefit from the software.

In our experience, most implementation services (e.g. configuration, data migration and conversion, interfacing, testing) usually could be performed by a third party that is not the cloud vendor.

Not distinct

If the implementation service could only be performed by the cloud vendor, then this indicates that it is not distinct from the access to the software.

For example, when the cloud vendor agrees to customise the software by modifying the existing software code or writing new code, this customisation service is generally not distinct.

In this case, the related implementation costs are recognised as an expense as the customer receives access to the customised software – i.e. over the contract term.

Applying the framework - Is there a separate intangible?

Does the expenditure give rise to a separate intangible asset under IAS 38?

Typically, no. In our experience, there are limited circumstances[1] in which a company recognises a separate intangible asset.

This is because the directly attributable costs of preparing software for its intended use are capitalised only when a company acquires a software intangible asset (see page 4).

A cloud service contract contains no such asset. Therefore, a company does not capitalise the directly attributable costs incurred to prepare the software for its intended use (e.g. configuration and testing).

[1] The costs to create a new interface between a company's existing software and the cloud software could create a separate intangible asset under IAS 38 – e.g. writing new software code that the company controls.

The framework illustrated

Configuration service

Company N enters into a cloud computing arrangement with Supplier T as follows:

– N has access to T's software for a period of five years for a fee of 500 per year.

– T also agrees to configure the software for N for a fee of 200.

Based on the fact pattern, N determines that it has a service contract with T – i.e. it does not control the software.

N determines how to account for the configuration costs using the framework.

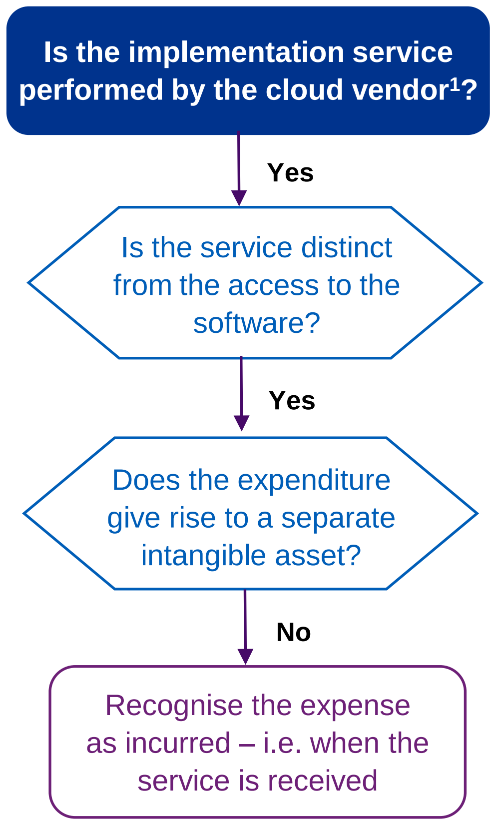
Is the service distinct from the access to the software?

Yes – N considers that a third party other than T could configure the software without also providing access to it. Therefore, N observes that T's configuration service is not integral to N's ability to derive its intended benefit from the software.

Does the expenditure give rise to a separate intangible asset?

No – This is because N does not control the configured software that it will access in the future.

Therefore, N **recognises an expense of 200** when it receives the configuration service. It also **recognises an annual expense of 500** over the five-year period of the cloud arrangement.



[1] Includes cases in which the cloud vendor subcontracts services to a third party.

The framework illustrated (cont.)

Customisation service

Company N enters into a cloud computing arrangement with Supplier T as follows:

- N has access to T's software for a period of five years for a fee of 500 per year.
- T also agrees to customise the software by writing new code that will create an entirely new functionality that does not yet exist for an additional fee of 300.
- T retains the intellectual property rights to the customised software and can make this new functionality available to other customers.

Based on the fact pattern, N determines that it has a service contract with T – i.e. it does not control the software.

N determines how to account for the customisation costs using the framework.

Is the service distinct from the access to the software?

No – N considers that only T is capable of modifying the underlying software code. Therefore, N observes that it is able to derive its intended benefit from the software only through T fulfilling both the ongoing access to the software and the customisation service. N concludes that there is one service in the contract: the access to the customised software.

N **recognises an annual expense of 560** over the five-year period of the cloud arrangement – i.e. (((500 x 5) + 300) / 5).

Is the implementation service performed by the cloud vendor[1]?

Yes

Is the service distinct from the access to the software?

No

Recognise the expense over the period of access to the software

[1] Includes cases in which the cloud vendor subcontracts services to a third party.

Some questions answered

When is a software intangible asset recognised in a cloud computing arrangement?

In some limited circumstances, a company may determine that it controls a software asset if:

- it has the right to restrict the access of others – e.g. the software vendor and its other customers – to the economic benefits flowing from the software; or
- it can obtain the benefits from the software without the software vendor's hosting services.

Features of a cloud computing arrangement that may indicate that the company obtains control of a software intangible asset include:

- the right to take possession of a copy of the software and run it on the company'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.

What implementation costs does a company capitalise when it controls a software intangible asset?

In the limited cases in which a customer controls a software intangible asset, the cost of that asset includes the directly attributable costs of preparing the software for its intended use. Under paragraph 28 of IAS 38, these costs include employee benefits and professional fees arising directly from bringing the software to its working condition, and costs to test whether the software functions properly.

Consistent with a cloud service contract, implementation costs that give rise to a separate intangible asset under IAS 38 are also capitalised (see page 7).

Therefore, many implementation costs such as testing, configuration and customisation of the software are capitalised because they form part of the cost of the software intangible asset.

This differs from a cloud service contract in which fewer implementation costs can be capitalised because the company does not control a software intangible asset.

Some questions answered (cont.)

What is the difference between configuration and customisation?

'Configuration' involves changing the default settings of the vendor's software to function in a particular way – e.g. setting various 'flags' or 'switches' within the vendor's software or defining certain values or parameters to implement a particular set-up of the software's existing functionality.

'Customisation' involves modifying the vendor's existing software code or writing new code to change or create additional functionalities.

In our experience, configuration services are typically distinct from the access to the software while customisation services are typically not distinct.

Is the accounting outcome for implementation costs driven by which party performs the service?

No. It is based on the nature of the service. When a party other than the cloud vendor performs the implementation service, no 'distinct' test is necessary. This is because the implementation service is inherently distinct.

Contractual restrictions requiring the customer to use the software vendor do not impact the analysis of whether an implementation service is distinct because it is based on the nature of the service.

If a cloud arrangement includes multiple distinct services that are received over different periods, then a company may need to allocate the total consideration paid to each service – e.g. based on the relative stand-alone price of each service.

What's next?

Agenda decision

- Consider the Committee's March 2021 agenda decision on *Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets)*.

Accounting policies

- Understand how your company might be affected by the Committee's agenda decision.
- Consider whether your current accounting policies remain appropriate or whether you need to change your accounting policy.
- If you are affected, then account for the resulting changes as a change in accounting policy – i.e. retrospectively.

Accounting systems and processes

- Consider whether you have the appropriate controls and processes in place.
- When entering into new cloud computing arrangements, think about the accounting implications in advance.
- You will need to ensure you have the systems, processes and controls to track and analyse different types of costs and allocate amounts paid to different services received.

If you would like to discuss any of these questions, please get in touch with your regular contact at KPMG Switzerland or one of the contacts below:

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