Cloud computing fees
FASB issues guidance on customer accounting

At a glance
On April 15, the FASB (the “Board”) issued new guidance on a customer’s accounting for fees paid in a cloud computing arrangement (CCA). Previously, there was no specific U.S. GAAP guidance on accounting for such fees from the customer’s perspective. Under the new standard, customers will apply the same criteria as vendors to determine whether a CCA contains a software license or is solely a service contract. For public companies, the new standard is effective for annual periods, including interim periods, beginning after December 15, 2015. For non-public companies, it is effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted.

Background
1 The lack of specific U.S. GAAP guidance on customer fees paid in a CCA has resulted in diversity in practice as to whether such fees are recorded as a software license or a service contract. The Board issued Accounting Standards Update 2015-05, Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement, as part of its simplification initiative to reduce the diversity in practice, and reduce the costs and complexity of assessing fees paid in a CCA. While the new standard does not provide explicit guidance on how to account for fees paid in a CCA, it does provide guidance on which existing accounting model should be applied.

2 For purposes of applying the new guidance, a CCA includes software-as-a-service (SaaS) and SaaS-type services. “Hosting” refers to situations in which the end user does not take possession of the software; instead, the software resides on the vendor’s or a third party’s hardware, and the customer accesses the software remotely.

Key provisions
3 Under the new standard, fees paid by a customer in a CCA will be within the scope of the internal-use software guidance if both of the following criteria are met:
   • The customer has the contractual right to take possession of the software at any time during the CCA period without significant penalty.
   • It is feasible for the customer to run the software on its own hardware (or to contract with another party to host the software).
The standard provides some guidance on how to interpret the term “significant penalty.” The ability to take delivery of the underlying software without significant cost and to use that software separately without a significant reduction in value would indicate there is not a significant penalty. Determining whether taking possession of the software will result in significant penalty will require judgment.

Arrangements that do not meet both of the criteria are considered service contracts, and separate accounting for a license will not be permitted. Arrangements that meet the criteria are considered multiple-element arrangements to purchase both a software license and a service of hosting the software. Existing guidance on internal-use software is applied to the purchased license.

Costs incurred by a customer in a CCA that includes a software license should be allocated between the license and hosting elements. The consideration should be allocated based on the relative fair value of each element. Determining the fair value of the software license and hosting service may require the use of estimates. Management should consider all relevant information, such as information from the negotiation process with the vendor, in estimating the fair value of the license. More observable inputs might be available to estimate the fair value of the hosting element.

Elimination of analogy to lease guidance

The new standard also eliminates the requirement that customers licensing internal-use software apply the leasing guidance by analogy to determine whether to record a software asset. Removing the analogy to the leasing guidance requires companies that purchase or license software to follow the same guidance for capitalization as any other purchased or licensed intangible asset.

Currently, the internal-use software guidance requires companies to apply the leasing guidance by analogy because the software guidance was modeled after fixed asset accounting. If an entity uses a fixed asset without owning the asset, lease accounting would apply. Since a license is the use of another entity’s asset, to be consistent with the fixed asset model, current guidance requires a company to apply the leasing guidance by analogy in determining whether to record an asset.

The Board decided, as part of the new standard, to make the accounting for acquired intangible assets consistent and eliminated the specific rule for internal-use software.
**PwC observation:**

The Board’s objective was to make the accounting for software licenses consistent with the accounting for all other licenses of intangible assets. The Board noted in the basis for conclusions to the new standard that this guidance could change the current accounting for those companies that treat a software license as an executory contract (that is, companies that do not record an asset by analogy to an operating lease). Therefore, the elimination of the analogy to lease accounting could cause more software assets to be capitalized. The recognition of an acquired intangible asset is required whether the intangible is acquired individually or as part of a group of assets.

Companies that determine they should record an asset for a software license may encounter operational difficulties in determining the amount and timing of capitalization for certain types of licenses, such as time-based licenses with auto renewal options.

If acquired as part of a group of assets, a software license will be capitalized at its relative fair value. Given the significant variability of the pricing of software, judgment will be required to determine the fair value of the software acquired for purposes of allocating the amount paid to all the acquired assets.

**Financial statement implications**

.10 A customer’s assessment of whether a CCA contains a software license could have a significant impact on its financial statements. For example, the accounting for an upfront fee paid in a CCA would differ depending on whether the fees are considered a payment for a software license or a prepayment for a service contract:

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.11 Companies that expect to have a change in classification under the new standard should also assess the follow-on impact to other areas of the business, such as debt covenants and incentive compensation plans.

**Transition and disclosure requirements**

.12 Companies will have the option of transitioning to the new guidance either retrospectively, or prospectively for all new transactions entered into or materially modified after the date of adoption.

.13 Public companies adopting prospectively will disclose the following in the first interim period and annual period after the effective date:

- Nature of and reason for the change in accounting principle
- Method of transition
- A qualitative description of the financial statement line items affected by the change in the first interim and annual periods after the effective date
.14 Public companies adopting retrospectively will disclose the following in the first annual period, and the interim periods within that annual period, after the effective date:

- Nature of and reason for the change in accounting principle
- Method of transition
- Description of previously reported information that has been adjusted
- Effect of the change on income from continuing operations, net income, other impacted financial statement line items, and any impacted per-share results for the current and prior periods
- Cumulative effect of the change on retained earnings as of the beginning of the earliest period presented

.15 All other companies should make the disclosures for prospective transition or retrospective transition, as applicable, in the first annual period after the adoption date. If the company elects to early adopt in an interim period, the entity should also make those disclosures in the interim periods within the first annual period after the adoption date.

What’s next

.16 The new standard is effective for public companies for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. For non-public companies, it is effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted for all companies.

.17 Prior to adoption, public companies should consider the disclosure requirements for recent accounting pronouncements detailed in Staff Accounting Bulletin (SAB) Topic 11-M (formerly SAB 74).