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Intangibles

Companies Confused About Upfront Fees for Cloud Services Rule

U.S. accounting rulemakers are considering whether to provide explicit guidance on how public and private companies should account for upfront implementation costs they incur when setting up cloud computing service contracts.

Confusion and broad differences in practice currently exist because there aren't specific accounting rules about how to book those costs, according to recent discussions at the Financial Accounting Standards Board and its private company advisory body.

Implementation fees arise from the additional steps a company must take to build connectors so its system can interact with a cloud arrangement. The costs are separate—and substantially higher—than the monthly hosting fee paid to the cloud company.

Some companies have booked millions of dollars of implementation fees as expenses in their income statements. Others book them as a prepaid asset and amortize the payment over the implementation period—typically nine months for a three-year contract.

''The financial institutions, especially in the community bank world, they just take a huge hit in the year that they actually convert to a new service provider and that's just the way it's always been, and then they just pay a fee ongoing,'' said Candace Wright, a director with Postlethwaite & Netterville, a Louisiana-based accounting and business advisory firm, and chair of FASB's private company advisers. ''Same thing that's happening in healthcare right now,'' Wright said.

Expensing the fee means a hit to a company's income statement, and ultimately retained earnings decrease, practitioners told Bloomberg BNA. ''We're talking about millions of dollars for a large scale ERP system, depending on what you're migrating from—really unbelievable amounts of money people have paid,'' said Wayne Spivak, President of SBA Consulting, Ltd., a Long Island, New York-based provider of project management system implementation to chief executive officers and chief financial officers.

ERP is enterprise resource planning—how a business coordinates the needed resources for the different parts of its business. Software applications have been developed to help companies with ERP. Some companies use ERP systems in the cloud to cut costs. Others have mixed environments in which part of ERP runs on company premises and part runs in the cloud.

''I did an implementation and was only one of many people on it—and only on one segment of it—and they probably spent hundreds of thousands of dollars, and I was only there for three months,'' Spivak said.

Companies Asking for Clarity Both financial statement preparers and users are seeking clarity about the accounting rules. Preparers say that the lack of explicit rules makes it confusing to divvy up and allocate the costs. Users say the absence of clarity prevents comparability of financial statements among companies, impairing the ability to analyze their performance.

The issue wasn't solved when FASB issued new rules in 2015, which gave criteria for determining if a cloud computing arrangement includes a software license. If it includes a software license, it would be accounted for in accordance with subtopic 350-40—Intangibles—Goodwill and Other—Internal-Use Software.

But most cloud computing arrangements don't meet the criteria, and so they are considered service contracts. Service contracts don't fall under subtopic subtopic 350-40 and aren't accounted for as an intangible asset.

Some of the challenges stem from differences in how preparers view the topic. Some of FASB's private company advisers told the board that in-house—meaning on premise—software licenses are virtually the same as cloud computing arrangements that are off-premise—meaning in the cloud.They therefore question why the accounting would be different.

''The implementation process is virtually identical to doing the traditional software license where you run everything on your servers versus you put everything in the cloud,'' said Timothy Curt, managing director and partner of Warburg Pincus LLC in New York. ''I'm struggling to understand why fundamentally the implementation accounting would be any different because the process that we've had to go through is virtually identical in implementing a cloud-based solution versus implementing an on-premises solution,'' he said during the advisory group meeting.

Some argue, however, that the differences stem from who has control. With an on-premise software license, the company has control of the license. If it is with a cloud computing vendor, and the cloud vendor goes out of business, the company no longer has the license.

The issue might be resolved if there were guidelines around how to parse the fees, the discussions implied. FASB could clarify what part of the implementation fee could be booked as a prepaid asset, what part should be expensed as incurred and what part should be booked as an intangible asset.

Book an Expense or Capitalize? Practitioners Bloomberg BNA spoke with were split between expensing or capitalizing the fees. ''From an academic perspective, I don't believe in capitalizing because I look at my balance sheet saying that I have an asset—that truly isn't an asset—I can't get a loan on it, the bank's not going to look at it,'' Spivak said. ''I just don't think it's a valid thing to capitalize it,'' he said.

Others say the fees should be capitalized because they're similar to those undertaken for an intangible asset, such as a software license. One practitioner said they are similar to deferred acquisition costs (DAC) typical of insurance contracts, which are amortized over the period of the contract.

''Those costs benefit the service period—term of the contract—and should be spread out accordingly,'' said Peter Vinci, a consultant at Resources Global Professionals (RGP), the operating subsidiary of Resources Connection, Inc., a multinational professional services firm that helps business leaders execute internal initiatives.

''Realistically, if the upfront costs are minimal—say industry wide—it would make no sense to capitalize,'' Vinci said. ''I have no visibility if such costs would be significant for a company or not. If significant, it appears to be an intangible asset, like DAC or a prepaid asset.''

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   ISSN 1558-6642