Potential Interpretations Committee agenda item request

This letter describes an issue that we believe should be added to the agenda of the IFRS Interpretations Committee. We have included a summary of the issue, diverse views, and an assessment against the Interpretations Committee criteria.

Issue

In its March 2019 decision on a *Customer's Right to Receive Access to the Supplier's Software Hosted on the Cloud (IAS 38 Intangible Assets)*, the Committee observed that a contract that conveys to the customer only the right to receive access to the supplier's application software in the future is a service contract – i.e. the customer does not receive a software asset. This letter addresses the accounting for costs incurred in relation to such a 'cloud service contract'.

We have observed diverse views and practice on the emerging issue of whether up-front costs of configuring or customising[1] the supplier's software to which access is being granted, should be capitalised or not. These costs of preparing the software for its intended use can be considerable. This topic was identified as an application issue at the time of the previous Committee discussions but was not addressed for scoping reasons.

We have observed three different treatments of configuration/ customisation costs: 1) capitalised as an intangible asset under IAS 38; 2) capitalised as a prepayment for future services; or 3) expensed as incurred. For the purposes of analysing the acceptability of these three treatments, the discussion below first considers whether there is an intangible asset and then whether there is a prepayment for future services.

Note that there is a difference between IFRS and US GAAP requirements. Under US GAAP, such costs in a cloud service contract are capitalised to the same extent as if they were incurred in respect of a controlled software intangible asset. This may be a factor in the emerging diversity.

Question 1: Are the costs of preparing the software for use capitalised under IAS 38 in a cloud service contract?

View 1: No, as there is no intangible asset

In a cloud service contract the customer does not control the software intangible asset. Therefore, the requirements of paragraph 27–28 of IAS 38 do not apply and there is no basis to capitalise the directly attributable costs of preparing the software for its intended use under IAS 38. That is to say, the access to the software is not an intangible asset, and so these costs cannot be the cost of any such intangible asset.

Nor can they be an intangible asset in their own right because they do not establish control of any asset that is separate from the access to the software under the service contract.

Under View 1, intangible asset treatment is ruled out.

[1] See Appendix 2 for further details on the meaning of configuration and customisation activities assumed herein.

View 2: Yes, there is an asset of some kind and the costs of preparing the software for its intended use should be capitalised as an intangible

The costs of preparing the software for its intended use enhance the entity's right to receive access to the software in the future. These costs give rise to future economic benefits (the definition of an asset in the Conceptual Framework) that will be consumed over the periods when the software is accessed and should therefore be capitalised as an asset. They are not tangible assets, and so they must be intangible assets.

Further, the economic substance of such costs is the same regardless of whether the customer obtains control of a software intangible asset or enters into a cloud service contract. Therefore, the accounting for these costs should be aligned – i.e. the costs should be capitalised.

Question 2: If the costs do not give rise to an intangible asset, are they expensed as incurred or capitalised as a prepayment for future services?[2]

View 1 – Expensed as incurred because the service is received up-front

Activities that prepare the software for its intended use are services. Under IAS 38.69, an entity recognises the expenditure as an expense when the services are received. IAS 38.69A clarifies that services are received when they are performed by a supplier in accordance with a contract to deliver them.

The services to prepare the software for its intended use are performed by the supplier up-front and the associated costs should be recognised when they are performed.

View 2 – Prepayment for future services because the configured/customised software will be accessed in the future

Although the supplier performs the service up-front, the customer receives the benefit of that service over the cloud contract term when it receives access to the software. The services are therefore received in the future and the costs should be capitalised as a prepayment asset.

View 3 – An entity uses a consistent framework to determine whether the service is separate from the access to the software (expensed as incurred) or part of one combined service (prepayment for future services)

An entity should assess the nature of the service to determine when it is received – i.e. is it separate from the service of receiving access to the software or is it part of one combined service?

There is no specific guidance in IFRS on how a customer identifies separate services within a contract that may contain multiple services. However, IFRS 15 and IFRS 16 address

[2] Note that Question 2 primarily arises when the activities are performed by the supplier of the cloud software. When the activities are performed up-front by internal company personnel it is not possible to argue that the entity receives services in the future.

similar and related issues from the perspective of the supplier in a revenue contract and a lessee in a contract that is, or contains, a lease.

Considering the principles in those standards, services that are capable of being provided separately by another supplier that does not also provide the access to the cloud software – e.g. configuration services – are separate from the service of receiving access to the software and the associated costs should be expensed as incurred. Conversely, a service that could only be performed by the cloud vendor – e.g. customising the underlying software code – is not separate from the service of receiving access to the customised software and the associated costs should be capitalised as a prepayment asset.

We believe that the Interpretations Committee should address this issue because it could have a significant effect on the financial statements of entities across all industries as companies shift from on-premise to cloud computing arrangements. Unlike with some other matters of accounting diversity, capitalising or not capitalising costs significantly affects comparability and the decision-making of users. Our assessment of this issue against the agenda criteria is included in Appendix 1 to this letter.

Appendix 1

Reasons for the Interpretations Committee to address the issues

a) ***Is the issue widespread and has, or is expected to have, a material effect on those affected?*** Yes. This issue is relevant for all companies that are customers in cloud computing arrangements that are service contracts. This population of impacted entities is expected to continue to increase as more businesses shift towards cloud computing arrangements. The significance for affected entities will also increase as they migrate more of their existing systems to the cloud.

b) ***Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?*** Yes. The issue affects whether implementation costs are expensed up-front or capitalised and amortised over a longer period. The comparability of financial statements would be improved if all customers in a cloud computing arrangement that is a service contract applied the same approach.

c) ***Can the issue be resolved efficiently within the confines of IFRS Standards and the Conceptual Framework for Financial Reporting?*** Yes. It relates to the application of requirements in IAS 38 to specific transactions. We note that the Committee has previously issued an agenda decision in relation to other aspects of these specific transactions.

d) ***Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS Standards?*** Yes. It relates to the application of requirements in IAS 38 to specific transactions. We note that the Committee has previously issued an agenda decision in relation to other aspects of these specific transactions. We also note that the issue is widespread.

e) ***Will the solution developed by the Interpretations Committee be effective for a reasonable time period?*** Yes. A project on IAS 38 is not currently on the IASB agenda. Although initial outreach by the Board in advance of the agenda consultation has indicated that some stakeholders may support a project on IAS 38, the timing and scope of any such project is unclear.

Appendix 2

Configuration - Typical configuration services relate to the setting of various ‘flags’ or ‘switches’ within the software, or defining certain values or parameters, to implement a particular set-up for the software’s existing functionality. Configuration does not involve the modification or writing of additional software code, but rather involves setting up the software’s existing code to function in a particular way.

Customisation - Typically involves modifying existing software code in the application or writing additional code. The effect of significantly altering or adding software code is generally to change, or create additional, functionalities within the software.

For the sake of clarity, there are other up-front costs for which we believe there is no diversity in views and these are not the subject of this submission. For example:

— training, data migration and conversion (expensed); and

— the development of interfaces with existing systems (capitalised because they are intangible assets in their own right or additions to existing (own systems) intangible assets, assuming the other the criteria in IAS 38 are met).