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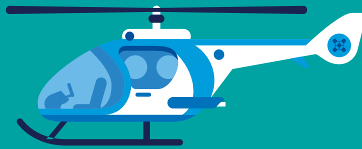

Defining Issues®

EITF reaches a final consensus on implementation costs for cloud computing and a consensus-for-exposure

June 8, 2018

EITF reaches consensus on cloud computing, consensus-for-exposure on revenue performance obligations in business combinations, and discusses episodic TV series.

Applicability

— **Cloud computing arrangements** (CCAs)[1] – all companies that are customers in either:

  – software licensing arrangements (includes 'hosting arrangements' that transfer a software license to the customer);[2] or
  – cloud computing arrangements (i.e. all hosting arrangements that do *not* transfer a software license to the customer).[3]

— **Recognition of revenue performance obligations in business combinations**[4] – all companies that acquire a revenue contract in a business combination after adopting ASC 606.[5]

— **Episodic television series**[6] – all companies in the film production and distribution industry that produce or license content.

Key facts and impacts

On June 7, the EITF reached a final consensus, subject to the FASB's ratification, that implementation costs incurred by customers in CCAs should be deferred if they would be capitalized by the customer in a software licensing arrangement under the internal-use software guidance. If, as expected, the FASB ratifies the EITF's consensus, an Accounting Standards Update (ASU) will be issued.

The EITF reached a consensus-for-exposure to align the recognition criteria for recognizing revenue performance obligations in a business combination with the definition of a performance obligation in ASC 606 and clarify the fair value measurement of those obligations.

The EITF discussed accounting for development costs of episodic television series and expressed a preference to align the cost capitalization for films and episodic content. The EITF asked the industry working group for further input on the related amortization and impairment models.

[1] EITF Issue No. 17-A, Customer's Accounting for Implementation, Setup, and Other Upfront Costs (Implementation Costs) Incurred in a Cloud Computing Arrangement That is Considered a Service Contract

[2] Hosting arrangements that meet the criteria in ASC 350-40-15-4A

[3] ASC Master Glossary, 350-40-15-4A – 14-4C

[4] EITF Issue No. 18-A, Recognition under Topic 805 for an Assumed Liability in a Revenue Contract

[5] ASC 606, Revenue from Contracts with Customers

[6] EITF Issue No. 18-B, Improvements to Accounting for Episodic Television Series

KPMG observation

The EITF's final consensus on cloud computing would require companies to defer potentially significant, specified implementation costs that are often expensed as incurred under current US GAAP and recognize them as expenses over the term of the CCA (plus optional renewal periods that are reasonably certain to be exercised by the customer). In addition to changing the timing of income statement recognition of these implementation costs, the new deferred implementation cost assets would affect companies' financial ratios and deferred tax accounting.

Cloud computing arrangements

Current US GAAP

US GAAP distinguishes between arrangements that transfer a software license to a customer[7], and CCAs, which provide the customer with the right to access software but do not, for accounting purposes, transfer a license.

Accounting for software licensing arrangements

A customer that acquires a software license, including in a hosting arrangement that transfers a software license, recognizes an intangible asset (i.e. the software license) and a corresponding liability to pay for it over time unless the license is prepaid.[8] Most implementation costs that relate to customization, configuration or installation are capitalized. Certain other costs such as data conversion[9], training and business process re-engineering, are expensed as incurred.[10]

Accounting for cloud computing arrangements

A CCA is accounted for as a service arrangement because no software license is conveyed to the customer.[11] The only amounts the customer recognizes on the balance sheet are those that result from the application of accrual accounting. For example, a customer recognizes a prepaid asset for fees paid in advance to the cloud service provider, and may recognize a liability for usage-based fees if it has not paid them at the financial reporting date.

Generally, most implementation costs are expensed as the related implementation activities are performed; they are not recognized over a longer period such as the CCA term. This occurs regardless of whether the costs are incurred for activities performed by internal resources, the cloud service provider or an unrelated third party (e.g. a consultant). Some of those costs may be expensed as incurred because they are business process re-engineering costs.

For more about the existing accounting for software licensing arrangements and CCAs, see KPMG's Defining Issues 18-1, EITF consensus-for-exposure on accounting for implementation costs of cloud computing arrangements.

Guidance unchanged

The final consensus would not affect the accounting by cloud service providers, other software vendors or customers' accounting for software licensing arrangements.

Deferral of implementation costs

Under the EITF consensus, costs incurred to implement a CCA (e.g. configuring the software to the customer's needs) would be deferred or expensed as incurred using the existing internal-use software guidance.

Implementation costs that are currently capitalized in software licensing arrangements would be deferred in CCAs, while those expensed as incurred (e.g. data conversion and training costs) would also be expensed in CCAs.

Generally this means that significant implementation costs (e.g. configuration costs) that are not addressed by other guidance would be deferred. The deferral would occur regardless of who performs the implementation services – i.e. internal resources, the cloud service provider or an unrelated third party.

Definition of implementation costs

The EITF decided that implementation costs did not need to be defined or illustrated.

[7] Includes hosting arrangements that meet the criteria in ASC 350-40-15-4A

[8] ASC 350-40-25-17

[9] Other than those incurred to acquire data conversion software, see ASC 350-40-25-3

[10] ASC 350-40-25-4 – 25-5; ASC 720-45, Other Expenses-–Business and Technology Reengineering

[11] ASC 350-40-15-4C

KPMG observation

Allocation considerations

Companies may engage a single cloud service provider or a third party to perform multiple implementation activities. Because not all implementation costs would be deferred under the EITF consensus (e.g. data conversion, training and business process re-engineering costs) companies would need to allocate costs between deferrable and non-deferrable implementation activities on a relative fair value basis (consistent with what is required for software licensing arrangements).

Capitalizable and non-capitalizable implementation costs

The EITF previously discussed these examples of implementation activities:[12]

- integration (developing interfaces between the hosted software and the company's other systems);
- customization of the company's other systems or the hosted software;
- configuration, either of the company's other systems or of the hosted software, data conversion or migration;
- installation;
- architecture and design;
- coding;
- testing;
- training; and
- business process re-engineering.

Recognition period

The EITF consensus would require companies to recognize the implementation costs as an expense over the term of the hosting arrangement, which is the period comprising the non-cancellable term of the CCA plus any optional renewal periods that are reasonably certain to be exercised by the customer or for which exercise of the option is controlled by the vendor. The FASB staff observed that 'reasonably certain' is a high threshold of likelihood, and the application of that term should be consistent with how it is applied under the new leases guidance.[13]

KPMG observation

Assessment of 'reasonably certain'

The proposed ASU stated that the company should consider all of these facts when determining the term of the hosting arrangement:

- obsolescence;
- technology;
- competition;
- other economic factors;
- rapid changes that may be occurring in the development of hosting arrangements or hosted software; and
- significant implementation costs that are expected to have significant economic value for the customer when the option to extend or terminate the hosting arrangement becomes exercisable.

We believe consideration of those factors, particularly consideration of significant implementation costs incurred and other economic factors such as switching costs, would frequently lead to a conclusion that the term of the hosting arrangement exceeds the non-cancellable period of the CCA.

[12] Issue Summary No. 1, Supplement No. 1, September 28, 2017

[13] ASC 842, Leases

KPMG observation

Absence of renewal options

The EITF concluded that the recognition period for the deferred costs should be aligned to the term of the hosting arrangement because the economic benefit that would be derived from those deferred costs in the future is inextricably linked to the customer having the continued right to access the hosted software.

CCAs may not include stated renewal options, even though the customer and the cloud service provider expect to agree on one or more renewals (e.g. through contract amendment).

Based on the EITF consensus, the recognition period for the deferred implementation costs in these cases would be limited to the non-cancellable term of the CCA. The term length may be considerably shorter than the period over which the customer reasonably expects to benefit from the costs incurred or expected term of the hosting arrangement if the CCA had included renewal options.

The EITF consensus may cause CCAs to include customer renewal options more frequently.

Impairment of deferred implementation costs

Deferred implementation costs would be assessed for impairment in the same manner as internal-use software assets.

This means deferred implementation costs would be subject to the impairment and abandonment guidance that applies to long-lived assets.[14]

Financial statement presentation	
Balance sheet	A company would present deferred implementation costs in the same line-item on the balance sheet as it would present a prepayment of fees for the CCA.
Income statement	The expense for deferred implementation costs would be presented in the income statement in the same manner as the CCA fees paid to the cloud service provider when recognized over the term of the hosting arrangement.
Cash flow statement	Cash payments for CCA implementation costs would be classified in the statement of cash flows consistent with how the fees for the CCA are classified. This would generally mean that these payments would be classified as cash outflows from operating activities.

KPMG observation

Consistency between CCA fees and implementation costs

The decisions on financial statement presentation reflect the preference of most EITF members to ensure a consistent link between the deferred implementation costs and the fees associated with the CCA contract.

The proposed guidance would result in the recognition of the expense for both aspects over time with consistent presentation throughout the financial statements.

EBITDA

Earnings before interest, taxes, depreciation and amortization (EBITDA) is a non-GAAP measure. Therefore, the ASU for the EITF consensus would not address whether amortization of the deferred implementation costs should be excluded in the calculation of EBITDA.

However, the FASB staff expressed the view that the term ‘amortization’ in the proposed ASU related to the recognition of the deferred costs, and was not intended to suggest that it would be appropriate to increase EBITDA by excluding the periodic recognition of deferred costs.

[14] ASC 360-10-35

Disclosure requirements

The EITF consensus would require a customer to disclose the nature of its hosting arrangements that are service contracts as well as certain quantitative and qualitative information about the amounts capitalized and the related amortization period and method.

The EITF decided not to require substantially similar disclosures for software licensing arrangements so the existing disclosure requirements would not change.

Effective date

— For public companies, interim and annual reporting periods in fiscal years beginning after December 15, 2019.

— For all others, annual reporting periods in fiscal years beginning after December 15, 2020, and interim reporting periods in fiscal years beginning one year later.

— Early adoption would be permitted.

Transition

A company would be able to choose:

— **Prospective transition** – all CCA implementation costs incurred after the effective date, including costs incurred on (1) new CCAs entered into on or after the effective date and (2) existing CCAs entered into before the effective date; or

— **Retrospective transition** – would require the consensus to be applied as if it had always been US GAAP.

Disclosures

A company would disclose the nature of, and reason for, the change in accounting principle, its transition method and qualitatively describe the financial statement line items affected by the accounting change. Retrospective adopters would quantitatively describe the effect of the accounting change.

Revenue performance obligations in a business combination

Currently the acquirer in a business combination recognizes liabilities assumed that meet the definition of a liability in the FASB Concepts Statements. However, EITF Issue 01-3[15] provided specific guidance that deferred revenue should only be recognized as a liability in a business combination if it represented a legal obligation. Although this EITF Issue was superseded, the recognition threshold of a 'legal obligation' has continued to be applied in practice.

ASC 606 established a definition of a performance obligation for revenue recognition purposes.[16] Questions have arisen about whether the ASC 606 definition of a performance obligation should be used to determine if a liability should be recognized for a revenue contract in a business combination **or** if the definition of a legal obligation should continue to be used. This could be a significant issue in scenarios involving the licensing of symbolic intellectual property (IP).

Example – Revenue performance obligation in a business combination

ABC Corp. acquires DEF Corp. in a business combination on July 1, 2018. DEF's business includes the licensing of intellectual property (IP) to its customers. DEF owns the IP, which is included in the acquired set in the business combination. One of the license agreements acquired in the business combination follows.

— DEF licensed the rights to use a cartoon character image (symbolic IP) to Customer XYZ for a period of 10 years. The contract term is from January 1, 2018, through December 31, 2027.

— XYZ paid DEF $20 million on January 1, 2018, for the entire license term.

— DEF has adopted ASC 606 as of January 1, 2018.

ASC 606 indicates that the license of symbolic IP is a performance obligation that is satisfied over time (the license term). The closing balance sheet of DEF on June 30, 2018, would include a contract liability of $19 million related to this agreement with XYZ (total consideration of $20 million less $1 million recognized as revenue in the first six months of the 10-year license term).

The EITF's proposed change would recognize a liability in the business combination accounting for the revenue arrangement. The liability would be measured at fair value, which may be fairly small (e.g. because DEF has already provided the character images to XYZ). Conversely, under the legal obligation approach currently applied in practice, no liability would be recognized.

[15] EITF Issue No. 01-3, Accounting in a Business Combination for Deferred Revenue of an Acquiree

[16] ASC 606-10-20

The EITF also reached a consensus-for-exposure that it is not appropriate for an acquirer to use carry-over basis to measure the value of a revenue performance obligation. Rather, the measurement should reflect the fair value of the *remaining obligation* that is assumed in a business combination. This proposed guidance would require that the fair value measurement of the liability take into consideration the related assets that were obtained in the acquisition. Under this approach, the fair value of the contract liability in the example would exclude the costs for a market participant to purchase the related IP because DEF already owns it.

Transition and effective date

The EITF tentatively decided to require a prospective transition method. Under this method, companies would apply the proposed guidance to business combinations that occur after the effective date. The EITF tentatively decided to propose an effective date in 2019 for public business entities and in 2020 for all other entities, with early adoption permitted.

KPMG observation

The EITF decided that the fair value measurement of contract liabilities should not include the cost to pay a market participant to assume that obligation. In the example, ABC would not be permitted to assume that a market participant would need to license the character images from the owner to fulfill the contract obligation.

If ABC included those costs in measuring the fair value of the obligation, it would likely result in a significantly higher fair value for the contract liability. That would result in the recognition of future revenue that the EITF did not believe should be recognized over the remaining contract term.

Episodic television series

There have been significant changes in the production and distribution models in the media and entertainment industry since the accounting guidance for the film industry[17] was originally issued. For example, the internet has continued to expand the distribution channels for content with the emergence of streaming services and content library subscriptions (e.g. Netflix, Hulu, Amazon Prime).

The FASB created a working group of preparers, accounting firms and investors to discuss a variety of issues for consideration related to the financial reporting for this industry. The EITF discussed input from the working group related to the guidance for capitalizing production costs and their amortization and impairment.

The EITF expressed a preference to align the cost capitalization guidance for episodic television content with the guidance that applies to films. This would remove restrictions on the capitalization of production costs for episodic television content. The EITF requested that the FASB staff and working group perform additional research and provide further input related to the amortization and impairment of those costs.

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KPMG's Financial Reporting View

kpmg.com/us/frv

kpmg.com/socialmedia

[17] ASC 926-20, Entertainment—Films, Other Assets—Film Costs