CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Financial Reporting Alert

ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES (ASPE) AND NOT-FOR-PROFIT ORGANIZATIONS (ASNPO)

JANUARY 2023

2022 New Accounting Guideline (AcG)-20, *Customer's Accounting for Cloud Computing Arrangements*

Highlights

On November 15, 2022, the Accounting Standards Board (AcSB or the Board) issued AcG-20, *Customer's Accounting for Cloud Computing Arrangements*.

The new Guideline does the following:

- clarifies that an enterprise shall determine a method on a rational and consistent basis for allocating the arrangement consideration to significant separable elements in a cloud computing arrangement
- provides an optional simplification approach to permit an enterprise to expense as incurred the expenditures in a cloud computing arrangement within the scope of the Guideline
- specifies that the enterprise must determine whether the software element is a software intangible asset or a software service if the simplification approach is not applied:
  - If the software element is an intangible asset, follow the guidance in Section 3064, *Goodwill and Intangible Assets* to account for the implementation costs.
  - If the software element is a service, then the Guideline provides a policy choice to capitalize qualifying implementation costs or expense implementation costs.
- requires the enterprise to disclose information to help users understand what costs are capitalized or expensed and the ongoing cash flow impact of implementing a cloud computing arrangement.

Background

The AcSB decided to add accounting for cloud computing arrangements from a customer's perspective to its workplan, based on input from its Private Enterprise Advisory Committee and Not-for-Profit Advisory Committee. Stakeholders informed the Board that there was diversity in the accounting for cloud computing arrangements. In addition, stakeholders expressed concerns with (1) the accounting outcome for expenditures on implementation activities in an arrangement that is a service contract and (2) the complexity in applying existing guidance.

The Board undertook research to better understand (1) the different types of cloud computing arrangements entered into by private enterprises and not-for-profit organizations and (2) the accounting issues related to these arrangements.

The project's objectives were as follows:

a. To address stakeholders' financial reporting concern of reflecting the economic benefits from implementing the software in a cloud computing arrangement that is a service contract.

b. To clarify the Sections to apply to account for cloud computing arrangements, including the disclosure requirements to improve information reported to users.

c. To simplify the existing requirements to address some of the difficulties and challenges with accounting for cloud computing arrangements.

The Board considered the work of other standard setters:

a. U.S. Financial Accounting Standards Board (FASB) issued amendments in 2015 and 2018 to address the customer's accounting for (1) fees paid in a cloud computing arrangement and (2) implementation costs when the arrangement is a service contract.

b. The IFRS Interpretations Committee of the International Accounting Standards Board (IFRS Interpretations Committee) issued agenda decisions in 2019 and 2021, clarifying how a customer accounts for a Software as a Service (SaaS) cloud computing arrangement and the costs of configuring or customizing the software in the arrangement.

The AcSB decided to address the issues through an Accounting Guideline because it thinks that having the guidance in one location would be simpler for stakeholders. Accounting Guidelines are a primary source of generally accepted accounting principles. They set out how existing Sections shall be applied in specific cases or the Board's conclusions on other particular issues of concern with respect to financial reporting. This AcG clarifies the way existing Sections 3064 shall be applied to cloud computing arrangements and the Board's conclusions on specific financial reporting concerns.

What Is the Scope and Purpose of AcG-20?

This Guideline provides guidance on the following:

a. accounting for a customer's expenditures in a cloud computing arrangement

b. determining whether a software intangible asset exists in the arrangement

Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets.

It is common that there are multiple elements in a cloud computing arrangement. For example, an enterprise may acquire new hardware to run the software from the cloud computing arrangement. AcG-20 does not address expenditures on property, plant and equipment, and right to use a tangible asset; they would be accounted for under Section 3061, *Property, Plant and Equipment,* or Section 3065, *Leases*.

What Is Cloud Computing?

In a cloud computing arrangement, a customer pays a subscription fee to a vendor to access a software. This is a shift from purchasing a software licence. The software is hosted on the vendor's cloud environment during the arrangement term. The vendor's cloud environment provides the infrastructure to support the running of the software, including providing the latest software updates.

Cloud computing is the on-demand delivery of computing resources over the Internet or a private network. Computing resources include software, servers, data storage, networking capabilities and more. There are different types of delivery models that describe the combination of computing resources a vendor provides, such as Software as a Service (SaaS). The way computing resources are delivered is referred to as the deployment model. A deployment model is the computing environment in which the computing resources reside, such as a cloud-based, on-premises or hybrid environment.

What Are the Recognition and Measurement Requirements Under AcG-20?

Cloud computing arrangements typically include a software element and activities to implement the software. These arrangements are usually multiple element arrangements. Therefore, at the inception of the cloud computing arrangement, the consideration is allocated to all significant separable elements.

AcG-20 does not prescribe an allocation method for the consideration. The enterprise shall determine a method for allocating the consideration on a rational and consistent basis. An enterprise may, but is not required to, adapt the allocation methods in Section 3400, *Revenue*.

The decision tree included in the Appendix summarizes the accounting for cloud computing arrangements for an enterprise that applies AcG-20. This is an extract from the Guideline.

Simplification Approach

The Guideline includes an optional simplification approach that permits an enterprise to expense as incurred the expenditures related to the elements in a cloud computing arrangement. This simplification approach is an accounting policy that shall be applied consistently to expenditures in all cloud computing arrangements.

In applying the simplification approach, the expenditures in the arrangement shall be treated as the supply of services. The enterprise shall recognize the expenditures related to the elements in the cloud computing arrangement within the scope of this Guideline as an expense as incurred. Guidance on recognition of an expense is provided in paragraphs 52-54 of Section 3064. Recognizing a prepayment as an asset is not precluded when payments for goods or services are made in advance.

If an enterprise applies this simplification approach, it is not required to perform an analysis to determine whether an intangible asset exists in the arrangement. Therefore, this approach would reduce the time and effort smaller enterprises spend on accounting for their cloud computing arrangements.

An enterprise that does not apply the simplification approach shall determine whether a software intangible element is a software intangible asset or a software service. The accounting for the implementation costs will depend on this determination.

Software Intangible Asset

A software element in a cloud computing arrangement is recognized as a software intangible asset if it meets the definition of an intangible asset and the recognition criteria in accordance with Section 3064.

Definition of intangible asset and recognition criteria

To be an intangible asset, the software element needs to be identifiable, controlled by the enterprise and having future economic benefits that would flow to the enterprise.

A software element normally meets the identifiable criterion because the software element would arise from contractual rights. The software element normally also meets the future economic benefits criterion because of the benefits that would flow to the enterprise from the use of the software.

An enterprise controls the software element if it has the power to obtain the future economic benefits flowing from the software and to restrict the access of others to those benefits:

- A software element is controlled by the enterprise if it has the contractual right to obtain the software without significant penalty, and it is feasible for the enterprise to run the software on its own or on a third party's infrastructure. "Without significant penalty" contains two distinct concepts:
  - the ability to take delivery of the software without incurring significant cost
  - the ability to use the software separately without a significant diminution in utility or value
- An enterprise may control the software element, based on factors other than or in addition to those considered in the previous bullet. Other factors that indicate control include, but are not limited to, the following:
  - exclusive rights to use the software or ownership of the intellectual property for customized software
  - decision-making rights to change how and for what purpose the software is used throughout the period of use

Software Service

A software element in the arrangement which does not meet the definition of an intangible asset and the recognition criteria in accordance with Section 3064 is a software service. An enterprise pays a subscription fee to access the software. The fee allocated to the software service shall be expensed as incurred.

Expenditures on Implementation Activities

An enterprise may incur expenditures to implement the software in the arrangement. Examples of implementation activities include this not exhaustive list:

- integration
- customization or coding
- configuration
- data conversion
- testing
- training
- business process reengineering

Accounting for implementation costs when a software intangible asset is recognized

- Expenditures on implementation activities that are directly attributable to preparing the software intangible asset for its intended use are capitalized as part of the cost of the software intangible, amortized over the useful life and tested for impairment in accordance with Section 3064, except for NFPOs for which such expenditures shall be tested for impairment in accordance with Section 4434, *Intangible Assets Held by Not-for-Profit Organizations*.
- Consideration should be made to determine whether any of the expenditures on implementation activities give rise to a separate intangible asset.
- Other expenditures are expensed as incurred – for example, training activities.

Accounting for implementation costs when the software element is a service

An enterprise that recognizes a software service shall make an accounting policy decision by picking one of the following options:

- To expense the expenditures on implementation activities as incurred.
- To capitalize the expenditures on implementation activities that are directly attributable to preparing the software service for its intended use as *assets for implementation of software services*. The amount capitalized will be expensed using a straight-line method over the expected period of access of the software service unless there is evidence that another method better reflects the pattern in which the enterprise expects to benefit from accessing the software.

AcG-20 provides guidance on accounting for subsequent expenditures as follows:

a. Expenditures that are directly attributable to enhancing the service potential of a software intangible asset are included in the carrying amount of the software intangible asset.

b. Expenditures that are directly attributable to enhancing the service potential of a software service are included in the carrying amount of the asset that was recognized.

c. Expenditures that are maintenance activities are expensed as incurred irrespective of whether they relate to a software intangible asset or software service.

AcG-20 also covers the following:

- factors to be considered in determining the expected period of access of the software service by the enterprise
- impairment testing for *assets for implementation of software services*

What Are the Presentation and Disclosure Requirements?

The Guideline contains presentation and disclosure requirements, including the following:

- a new balance sheet caption to present capitalized expenditures on implementation activities when the cloud computing arrangement is a software service
- disclosures if the enterprise applies the simplification approach
- disclosures if an enterprise does not apply the simplification approach

What Are the Effective Date and Transitional Provisions?

The Guideline applies to annual financial statements relating to fiscal years beginning on or after January 1, 2024. Earlier application is permitted.

An enterprise that applies the simplification approach shall apply the Guideline retrospectively in accordance with Section 1506, *Accounting Changes*.

An enterprise that does not apply the simplification approach shall apply the Guideline as follows:

a. retrospectively in accordance with Section 1506; or

b. retrospectively only to expenditures on implementation activities incurred in a cloud computing arrangement on or after the beginning of the earliest period presented in the financial statements in which the enterprise first applies the Guideline.

If an enterprise applies the transitional provision described in paragraph b) above, it is also required to apply the Guideline retrospectively to any previously recognized assets resulting from a cloud computing arrangement. Any adjustment to those assets in respect of applying the Guideline shall be recorded in opening retained earnings of the earliest period presented.

Consequential Amendments

Significant consequential amendments to the *Handbook* are as follows:

- Section 3064, *Goodwill and Intangible Assets* – Referring to AcG-20
- Section 1506, *Accounting Changes* – Adding AcG-20 as a situation when an enterprise may change its accounting policy without meeting the "more relevant information" criterion described in paragraph 1506.06(b)

What Resources Are Available to Help Me?

The Guideline provides three illustrative examples:

- one example reflecting the application when the simplification approach is applied
- two examples reflecting the application when the simplification approach is not applied

Accounting Standards Board

- AcG-20, *Customer's Accounting for Cloud Computing Arrangements*
- [Meetings and Events (frascanada.ca)]

Comments

Comments on this *Financial Reporting Alert*, or suggestions for future Financial Reporting Alerts should be sent to:

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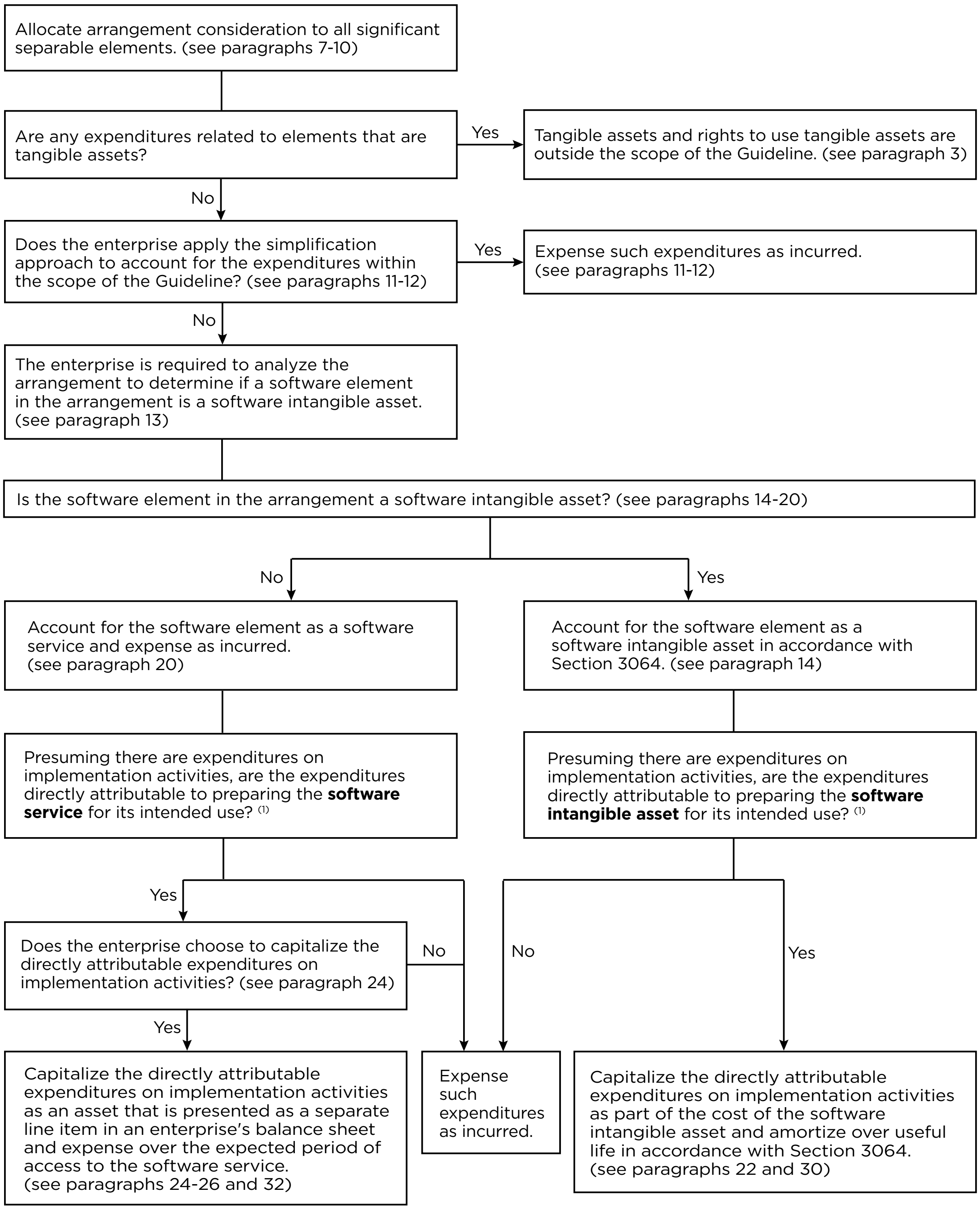
APPENDIX

This Decision Tree is illustrative only (excerpt from AcG-20).



(1) An enterprise shall also consider paragraph 23 to determine whether any of the expenditures on implementation activities give rise to a separate intangible asset.