



## AMERICAN ACCOUNTING ASSOCIATION

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Thank you for giving us the opportunity to comment on the Financial Accounting Standards Board's "*Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*" Exposure Draft (ED/March 1, 2018). Please refer to the attached letter for our comments.

Sincerely yours,

Teri Lombardi Yohn, Chair  
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**Response to the FASB Invitation to Comment: Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (ED/March 1, 2018)**

**Financial Reporting Policy Committee of the American Accounting Association’s Financial Accounting and Reporting Section**

**April 30<sup>th</sup> 2018**

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**ABSTRACT**

In this comment letter, our committee (the Financial Reporting Policy Committee of the American Accounting Association’s Financial Accounting and Reporting Section) provides comments on the Financial Accounting Standards Board’s Exposure Draft, “Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract” Exposure Draft (ED/March 1, 2018). Instead of responding to specific questions, we summarize some relevant literature that can be used to evaluate the issues in this Exposure Draft. Specifically, academic research implies that: (1) managers sometimes use the discretion inherent in rules similar to the capitalization of implementation costs in a way that manages earnings and inflates assets, (2) the propensity for managers to behave opportunistically appears to diminish as mandatory disclosure improves, and (3) if the implementation costs are not capitalized, investors would be able to at least partially value the future benefits associated with these costs (although sophisticated investors would be at an advantage in doing so). Furthermore, the prior literature related to operating leases provides an illustration of the “accounting subsidy” about which the dissenting views to the ED express concern. Finally, academic research suggests that when early adoption has been permitted in prior standards, firms sometimes use the discretion in early adoption for their own interests (i.e., to manage the appearance of their financial statements).

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<sup>1</sup> The comments in this letter reflect the views of the Committee and are not an official position of the American Accounting Association, the Financial Accounting and Reporting Section, the International Accounting Section, or the American Taxation Association.

## I. INTRODUCTION

The Financial Reporting Policy Committee (hereafter, the Committee) of the Financial Accounting and Reporting Section (FARS) of the American Accounting Association (AAA) is charged with “evaluating official standard-setting releases related to financial accounting and reporting as they are released...and providing timely, substantive, and constructive written feedback that is grounded in relevant academic research.”<sup>2</sup> The Committee is pleased to provide the Financial Accounting Standards Board (hereafter, the FASB) comments on the Exposure Draft (ED/March 1, 2018), “*Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract.*”

The FASB’s Exposure Draft (ED/March 1, 2018) “*Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*” (hereafter, the ED, or Implementation Costs) invites responses on 11 questions. Rather than responding to each question separately, we provide a review of the academic literature that we deem relevant to the issue at hand. For practical purposes, we are unable to provide a synthesis of the entire academic literature. We have chosen to focus on studies that provide empirical evidence (both archival and experimental) and on studies that have been published recently or are currently in process.

### *Discussion of related academic literature*

There is no direct academic research on whether implementation costs meet the definition of an asset on a standalone basis, or whether capitalizing these costs would create an “accounting subsidy” that would alter the economic behavior of firms. However, the decision of whether or not to capitalize implementation costs in a hosting arrangement has parallels to the decision to capitalize some R&D and intangible costs, and is related to the implications of reporting operating lease arrangements off balance sheet rather than capitalizing them. We draw on these streams of literature and describe the key findings that can potentially be useful when evaluating the specifics of implementation costs associated with hosting arrangements.

When considering whether R&D and other intangibles should be capitalized or whether operating leases should be reported on the balance sheet, the literature addresses the following questions: (i) Does discretion in the reporting of intangible assets enhance or reduce investors’ information, and (ii) Do investors see through biased reporting to understand the true economics of the transactions. We discuss each below.

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<sup>2</sup> American Accounting Association (2012).

***(i) Does discretion in the reporting of intangible assets enhance or reduce investors' information?***

Academic research suggests that managers sometimes exploit the discretion inherent in deciding the amount of intangible assets to record (and thus the amount of expenses to defer) to manage their financial statements. For example, Beatty and Weber (2006) find that, with respect to purchase accounting, managers' decisions to include items in income depend on their incentives that arise from equity investors, debt contracting, bonus contracting, career concerns, and exchange listing requirements. Bens, Heltzer, and Segal (2011) document similar findings. There is also evidence that firms used political lobbying dollars to fight for enhanced discretion in FAS 141/142, presumably to be able to exploit the discretion (Ramanna 2008). Related to these findings, recent evidence suggests that goodwill balances are inflated after FAS 141/142 and are not impaired in a timely manner, indicating that the discretion under the impairment model for goodwill (as opposed to amortization) has been exploited for self-serving purposes (Li and Sloan 2017; Ayres, Campbell, Chyz, and Shipman 2018). Finally, research suggests that firms facing bankruptcy are more aggressive with respect to capitalizing intangible assets than firms that are not facing bankruptcy, particularly over the five-year period leading up to firm failure (Jones 2011).

However, there is also evidence that managers use the discretion allowed in intangible asset accounting to better reflect their firms' economic position. For example, Wyatt (2005) finds that when firms have the discretion over recording intangible assets, the intangible assets that they record reflect the underlying economics of the intangibles better than when the choice to record is more regulated. In a similar vein, Aboody and Lev (1998) find that "For a sample of 163 firms during the period 1987-95...annually capitalized development costs are positively associated with stock returns and the cumulative software asset reported on the balance sheet is associated with stock prices. Furthermore, software capitalization data are associated with subsequent reported earnings, indicating another dimension of relevance to investors. We find no support for the view that the judgment involved in software capitalization decreases the quality of reported earnings." Furthermore, research finds that auditors reduce their risk assessments when firms capitalize internally-developed software costs (Krishnan and Wang 2014), suggesting that auditors believe that the assets represent future economic benefits rather than an indication that managers are opportunistically exploiting the discretion in software capitalization accounting rules. Finally, research suggests that capitalizing R&D costs encourages managers to provide higher quality voluntary disclosures about the projects that are capitalized (Chen, Gaviious, and Lev 2017).

Overall, the findings in the academic accounting research are mixed. For example, the key issues related to whether capitalization or expensing of R&D costs are appropriate are: (1) the uncertainty to which the costs will result in future benefits, and (2) the extent to which the costs result in an identifiable benefit over which the firm has property rights (Wyatt 2005; Greenhalgh and Rogers 2006). Research argues that capitalization (rather than expensing) is preferred when the uncertainty about future benefits is relatively low and the firm has property rights over the

benefits. In the case of Implementation Costs, regulators would need to consider the extent to which it could be argued that both of these conditions (i.e., low uncertainty and high property rights) are met. Furthermore, academic research documents a number of instances where managers appear to misuse their discretion to distort firm performance and “over capitalize” intangible assets. This implies, in the current context, that allowing for the capitalization of implementation costs will provide managers with a greater ability to manage earnings and inflate assets by choosing what amount to capitalize and when (and how much) to amortize. To the extent that it is determined that disclosure of implementation costs is preferable to capitalization, prior research suggests that mandatory disclosures about costs with highly uncertain (i.e., intangible) future benefits actually encourage firms to do a better job tracking and managing these costs, and result in more efficient and profitable allocation of firm resources (Wyatt 2008; Hunter, Webster, and Wyatt 2012).

***(ii) Do investors see through the reporting to understand the true economics of the transactions?***

The above evidence then raises the question – if firms are *not* allowed to capitalize implementation costs, will investors understand that the economic transactions underlying these costs represent future benefits to the firm? Prior research in the R&D setting suggests that investors understand the value of intangible assets even if they are not recorded on the balance sheet. Specifically, prior research suggests that investors estimate the value of previously-expensed R&D and incorporate it into the market value, even though it is not recognized as an intangible asset on the balance sheet (Lev and Sougiannis 1996; Ritter and Wells 2006; Wyatt 2005; Matolcsy and Wyatt 2006). Furthermore, research suggests that equity and debt investors consider both the benefits of R&D expenses (i.e., higher expected future cash flows) and the costs of R&D expenses (i.e., higher expected variance of future cash flows) when considering the implications of R&D expense on firm value (Shi 2003).

A critical limitation with these studies, of course, is that we cannot know the extent to which investors would value R&D expenses differently if they were capitalized. Furthermore, research suggests that sophisticated investors (i.e., institutional investors, hedge funds, etc.) have an advantage in pricing items that are disclosed rather than recognized on the balance sheet (e.g., Yu 2012; Muller, Riedl, and Sellhorn 2015; Campbell, D’Adduzio, Downes, and Utke 2018). Thus, failing to recognize the Implementation Costs on the balance sheet (and relying on disclosure to inform investors) may lead to advantages in information processing for sophisticated investors.

Overall, research suggests that, as long as there is sufficient disclosure, investors are able to see through the reporting of expenses and consider the future benefits (as is the case with implementation costs), although more sophisticated investors have an advantage in doing so.

### *Academic literature related to the “dissenting view”*

In the dissenting view, Ms. Botosan and Mr. Siegel express a concern that “capitalizing the costs incurred in implementing a cloud computing arrangement that is a service contract is contrary to the conceptual framework. They do not believe that such costs, in and of themselves, meet the definition of an asset and believe that the proposed Update, which treats such costs as assets on a standalone basis, does not faithfully represent the economics of the arrangement” (BC 20, Exposure Draft). While there is little academic research directly on this issue, we think it is relevant to note that, in an analogous situation, AcSEC SOP 98-5 “Reporting on the Costs of Start-Up Activities” requires firms to expense costs incurred in starting new lines of business. McDonald and Noll (1998) argue that the guidance on accounting for start-up costs was issued because (1) of the difficulty in precisely defining start-up costs and (2) start-up costs did not fit the definition of an asset. These arguments seem to fit with the dissenting views of Ms. Botosan and Mr. Siegel.

In addition, Ms. Botosan and Mr. Siegel express a concern that “the proposed accounting...could give rise to an ‘accounting subsidy’ resulting in contract or transaction structuring to obtain a preferred accounting outcome” (BC 24, Exposure Draft). This concern seems analogous to the proliferation of leasing companies that developed after FAS 13 paved the way for operating leases to be given off-balance sheet treatment. Therefore, we consider it worthwhile to summarize the accounting literature related to operating leases.

Returning to the original questions, research on leases is clearer and suggests that providing managers with discretion to not capitalize leases (i.e. structuring transactions for operating lease treatment) leads to lower quality investor information. Dechow, Ge, Larson, Sloan (2011) find that firm-years with overstated earnings have higher usage and initiation of operating leases. They view operating leases as a “legal earnings management option,” at least in the early years of the lease. Further, Imhoff, Lipe, and Wright (1997) argue that operating lease treatment distorts financial ratios, and make a case for capitalization. Finally, Ge (2006) shows that operating leases affect earnings persistence by inflating earnings early on and then reducing earnings in the future.

Furthermore, research on leases suggests that off-balance sheet operating leases are considered to be “leverage,” but not to the same extent as capital leases (Dhaliwal, Lee, and Neamtiu, 2011). This suggests that, at least to some extent, investors view the financial effects of operating leases as if they were capitalized regardless of the firm’s reporting choice. However, as before, a limitation of this research is that we cannot know whether the documented pricing reflects the “full pricing” that would occur if all investors understood the economics behind operating leases. In fact, Ge, Imhoff, and Lee (2008) argue that investors do not fully recognize and incorporate the economic substance of operating leases. Furthermore, as noted before, not all capital market participants view this issue similarly. Lim, Mann, Mihov (2003) document that off-balance sheet operating leases are not *fully* reflected in debt ratings, allowing the firm to have a higher credit rating. However, bond yields appear to price the off-balance sheet lease liability similar to reported debt, suggesting that debt investors fully consider the risk in operating leases

even though ratings agencies may overlook them. Finally, Ge (2006) shows that investors misestimate earnings persistence when there is an operating lease and extrapolate the higher initial earnings into the future, resulting in mispricing.

Overall, the findings of this research are similar to the findings discussed earlier and support the concerns raised by Ms. Botosan and Mr. Siegel. Specifically, in other contexts (i.e., lease accounting), managers have structured transactions around accounting rules in ways that reduce earnings quality and fundamentally alter contractual relationships. Furthermore, while investors appear to discern the economics of these transactions, a concern remains that sophisticated investors have an advantage in doing so.

### ***Implications of allowing early adoption of the accounting rule***

The academic literature has examined the motives for early adoption of new accounting standards and the differences in the characteristics of early versus late adopters. The central question is whether the benefits associated with the choice of early adoption outweigh the costs incurred by the users having to analyze incomparable, and potentially managed financial reports. Scott (1991) and Sami and Welsh (1992) study the characteristics of early and late adopters of pension accounting standards, and find evidence of systematic differences between firms that adopt the standard early and those that adopt on time. Their evidence is consistent with selective adoption of a standard when it benefits the firm, and questions the policy of a flexible transition period.

Similarly, in the context of accounting for income taxes, Gujarathi and Hoskin (1992) find that firms use discretion over both the timing of adoption and the transition method to manage earnings. Consistent with the hypothesis that firms use early adoption as a strategic financial reporting opportunity, they find that beneficial financial statement effects explain the rationale for early adoption even in the midst of implementation difficulties. In the context of early adoption of SEC rules, Asthana and Krishnan (2006) find that companies that had the most to gain from the new rules adopted them earlier than required.

In summary, accounting research has found costs related to early adoption in the form of incomparable or biased financial reporting. On the other hand, the research has not addressed whether investors correct for these deficiencies or whether they benefit from the earlier access to information that early adoption provides.

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