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April 30, 2018

VIA EMAIL TO: director@FASB.org

Financial Accounting Standards Board
Attn: Technical Director
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 2018-230

Proposed Accounting Standards Update, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract; Disclosures for Implementation Costs Incurred for Internal-Use Software and Cloud Computing Arrangements*

Members of the Financial Accounting Standards Board:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We are writing to provide comments on the FASB’s Proposed Accounting Standards Update, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract; Disclosures for Implementation Costs Incurred for Internal-Use Software and Cloud Computing Arrangements* (the “Proposed ASU”).

Executive Summary

We are sympathetic with the concerns that led the Board to add the accounting for costs of cloud computing service contracts to its agenda. We acknowledge that the costs to implement a cloud computing arrangement can be significant regardless of whether the contract includes a software license. We also appreciate the desire to find a pragmatic solution to an issue that presents a sense of immediacy.

However, we strongly object to the conclusions set forth in the Proposed ASU. Our concerns fully align with the issues raised by two Board members in the Alternative Views (paragraphs BC20 through BC26). We find their positions to be well reasoned, clearly articulated and conceptually grounded. The positions in the Proposed ASU, in contrast, are not. We do not believe the accounting model in the Proposed ASU improves financial reporting. In our view, finalizing the ASU as proposed would establish an inappropriate and unsound precedent and could lead to more problems than it solves.

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The Proposed ASU frames the issue as “implementation costs for a cloud computing arrangement that is a service contract.” We believe the question being considered by the EITF can be addressed in a more useful manner if it is framed as being software related. Specifically, how should an entity account for the cost of software rights-of-use that are embedded in a noncancelable hosting service contract?

Existing accounting literature addresses internal-use software that a company develops, purchases or licenses. It does not address software with otherwise identical functionality that is provided by a third party as a service. In fact, the accounting guidance makes an important distinction between “taking possession” of software code and “having the right to access” software code. That distinction is not limited to software: it applies to any intellectual property. “Access” represents a service that is expensed as incurred. “Possession” represents an asset.

The issue addressed in the Proposed ASU arises because many in the business world do not view the differences identified by current literature as substantive. Instead, they view the noncancelable right to access software via a hosting arrangement as substantially equivalent to a term license in which they can take possession of the software. They believe the costs incurred to customize, configure and implement the hosted software are substantially the same in either situation. And they believe the benefits that accrue from using the customized software are substantially the same whether it is hosted or resident on company-owned hardware.

The broad issue of rights of use/access to intellectual property and the costs and obligations associated with those arrangements cannot be solved quickly. However, we believe the narrow issue of costs and obligations of software rights-of-use that are embedded in a noncancelable hosting service contract can be. We offer two alternatives:

Alternative A: Permit an analogy to the literature on internal-use software for the noncancelable contractual rights of use to third party software that are embedded in a hosting service contract.

Alternative B: Broaden the definition of “internal-use software” to include noncancelable contractual rights of use that are not the subject of a license.

Both alternatives would result in an entity accounting for the internal-use software component of a hosting service contract consistent with internal-use software that is owned or licensed. Similar assets would be recognized, similar costs would be capitalized, similar liabilities would be recorded, and similar expenses would be recognized in similar periods. The result would be consistent accounting for what we are told are similar economic arrangements.

In contrast, although the Proposed ASU would treat implementation costs similarly, it would not recognize an asset and liability for the right to access the software. In effect, it would establish a new accounting model for implementation costs of service contracts. While the Proposed ASU attempts to justify the new model by saying that service contracts involving software are different from other service contracts, it nonetheless invites (literally, in the Basis for Conclusions) analogies to other types of executory contracts. We find this both curious and troublesome. Why would the Board choose to create an accounting model that applies so broadly in the context of such a narrow discussion?

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In the balance of this letter, we explore our concerns about the Proposed ASU in more depth. We also elaborate on the two alternative approaches to addressing the question presented by the FASB to the EITF.

Concerns about the Proposed ASU

We have three principal, albeit interrelated, concerns.

1. **The costs that would be capitalized do not represent an asset.** The EITF concludes that implementation costs are an asset because they are “attached” to an off balance sheet asset (the at-market contract to receive services). We find that argument circuitous and unconvincing. In particular, we are not persuaded that the contractual right to receive services and the corresponding contractual obligation to pay for those services meets the definition of an asset when the contract’s terms are at market. While we recognize that companies invest significant resources to develop vendor relationships, negotiate contracts and set up an infrastructure to maximize the benefits of long term supply contracts, we believe that the benefits accruing from these investments represent internally generated goodwill.

The Proposed ASU suggests that implementation costs associated with a service contract represent an asset in the same way that costs incurred to fulfill a customer contract represent an asset, as provided in ASC Subtopic 340-40. However, costs incurred to fulfill a customer contract represent an asset because such costs provide resources the entity will use to settle an obligation. The purchaser of services under a contract to access software in the cloud has no such obligation. Thus, implementation costs incurred in connection with a service contract are not analogous to costs incurred to fulfill a contract with a customer.

2. **The proposed accounting model is not conceptually sound and, as a result, is internally inconsistent.** The Proposed ASU appears to vacillate between two different accounting issues: (a) implementation, setup and other upfront costs of a noncancelable supply contract and (b) the development, customization, configuration and other similar application stage costs related to the software component of a noncancelable hosting services contract. That lack of clarity combined with the nebulous conceptual basis for the asset leads to a proposal that is confusing and inconsistent.

The Proposed ASU seems to lean towards a model consistent with the costs of building and installing an asset by stating that depreciation should begin when a module is ready for its intended use (even if it has not yet been placed in service), by requiring that obsolescence and technology be considered when estimating the asset’s useful life, and by assessing the asset for impairment under ASC Topic 360. However, it deviates from the model for building and installing an asset by not recording, as an asset, the expenditures to acquire the asset.

If there is no asset for the contractual right to use the software and no liability for the obligation to pay for that right of use, then the logical basis for capitalizing upfront costs associated with the right of use must be that they represent the costs of obtaining a service. The upfront cost to obtain a service is not an intangible asset that is depreciated over its estimated useful life and assessed for impairment based on ASC Topic 360. Rather, it represents a prepayment that is expensed over the period the service is provided.

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The accounting model contained in the Proposed ASU mixes and matches between the accounting for building and installing a long-lived asset and the accounting for prepaid expenses. In our view, the confused blending of these two accounting concepts is a tortured attempt to reach a desired answer in which implementation costs are treated as costs of installing a long-lived asset while the actual costs of acquiring the long-lived asset are treated as period costs. The Proposed ASU would thus establish an entirely new accounting model for the capitalization of upfront costs of obtaining a service contract, a model that is not necessarily limited to a cloud computing services contract.

- 3. The proposed accounting model results in financial reporting that is not economically neutral or representationally faithful.** We believe the Proposed ASU provides a structuring opportunity for an entity that views a fixed term, noncancelable right to access software via a hosting arrangement as substantially equivalent to a term license for software. Such an entity can avoid adding the value of the software license and the obligation to pay for that license to its balance sheet, while capitalizing the same upfront costs as if it had obtained a license.

We believe the issues addressed in the Proposed ASU are subsets of broader issues. With respect to intellectual property, the financial reporting model is potentially out of step with the way businesses currently develop, own, deploy, use, access, commercialize and monetize intellectual property. With respect to the upfront costs of obtaining and implementing contracts, the financial reporting model is piecemeal. The Proposed ASU exposes these shortcomings of existing literature. It also, unfortunately, crafts an approach that exacerbates them.

Alternative Models

There appears to be general agreement among customers and providers of cloud computing services that there is no substantive difference between a cloud computing hosting contract that contains a license and one that provides the same services and functionality without a software license.

Building on that view, we believe that the issue of accounting for software rights-of-use embedded in a hosting service contract and the costs of implementing the related software could be resolved in one of two ways:

Alternative A: Permit an analogy to the literature on internal-use software for the software component of hosting arrangements that provide an entity with contractual rights of use to third party software. We believe this approach could be explored by the EITF because it builds on existing GAAP.

For those that elect the analogy, the cost of customizing, configuring and implementing the software would be capitalized, as would the cost of using the software, consistent with the model for internal-use software. A liability equal to the right of use software asset would be recorded. For purposes of determining the cost of the noncancelable right of use and related liability, renewals that are within the company's control should be considered only if there is evidence that the software will not be significantly modified or enhanced during the renewal period. No special guidance on amortization or impairment would be needed and no incremental disclosure requirements would be required.

Permitting (but not requiring) such an analogy would allow an entity to choose either 1) the internal-use software model, including capitalization of the right to use software and related

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implementation costs, or 2) the service contract model, in which both implementation costs (that are not capitalized pursuant to other provisions of GAAP) and costs of using the software would be expensed as incurred.

The EITF would need to address whether this accounting choice would apply to “off the shelf” hosted software, i.e., software that requires little to no customization. I

The EITF might also wish to explicitly address whether noncancelable rights of use to software represent an identifiable intangible asset in a business combination.

Alternative B: Broaden the definition of “internal-use software” to include contractual rights of use that are not the subject of a license. Because this would require rescinding ASU No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, we believe this alternative would need to be addressed by the FASB.

Alternative B might be preferable because it streamlines the accounting literature by eliminating the requirement in paragraph 350-40-15-4A to evaluate whether the entity has the right to take possession of the software.

We recognize that Alternative B would create a distinction between the revenue recognition model (which respects the form of a license) and the asset acquisition model (which would look at the substance of the contractual rights). However, a distinction in the accounting for rights of use for software would not be inconsistent with lessor/lessee distinctions in Topic 842.

These two alternatives are not sufficient to resolve the broad issues of accounting for rights of use associated with intellectual property or upfront costs of obtaining and implementing long term service contracts. They also would not address needed improvements to the accounting for internal-use software. But we believe they would resolve the immediate issue in a manner that is economically neutral, representationally faithful and conceptually grounded.

Our responses to the questions posed in the Proposed ASU follow in Appendix A. Some of our responses elaborate more on the above.

We appreciate the opportunity to convey our views. If you have any questions, please feel free to contact Amy Ripepi (312-345-9103) or, Scott Taub (312-345-9105).

Sincerely,



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Appendix A

Responses to Questions

Question 1: *Should eligible implementation costs of a hosting arrangement that is a service contract be capitalized using the guidance on internal-use software, recognized in profit or loss over the term of the hosting arrangement as defined in this proposed Update, and presented in the same line item in the statement of income as the fee associated with the hosting arrangement? If not, what accounting is more appropriate and why?*

Response: If the costs of accessing the software itself are not to be capitalized as an asset, we do not believe the implementation costs should be capitalized either. As noted above, such costs do not represent an asset in and of themselves, and the analogy to ASC 340-40 is inappropriate, as the costs are not similar.

In the event that it is nonetheless determined that such costs should be capitalized, they should be recognized in income over the term of the service arrangement, and in the same line item in the statement of income. Most importantly, it should be clear that such costs do not represent amortization of an intangible asset, but instead the costs of obtaining service.

Question 2: *This proposed Update includes an amendment to the definition of hosting arrangement in the Master Glossary. Do you agree with the amendment, and do you have any other concerns with the definition, as amended?*

Response: We have no objection to the amended definition of *hosting arrangement* in the Master Glossary.

Question 3: *Is additional guidance needed to determine whether the amendments in this proposed Update apply to arrangements that include a minor hosting arrangement?*

Response: We do not believe that whether the hosting services are “major” or “minor” is a relevant distinction.

Question 4: *Can the guidance for determining the project stage (that is, preliminary project stage, application development stage, or post implementation stage) in Subtopic 350-40 be consistently applied to a hosting arrangement? Why or why not?*

Response: We do not believe there is anything about the method of accessing the software (cloud vs. on-premise) that affects the ability to apply the guidance on determining the project stage.

Question 5: *Should an entity apply an impairment model to implementation costs of a hosting arrangement that is a service contract that is different from the impairment model included in Subtopic 350-40? Why or why not?*

Response: If the costs of purchasing the right to use the software are not capitalized, we do not believe that the impairment model in ASC Subtopic 350-40 is appropriate to evaluate capitalized implementation costs for impairment. Such capitalized costs are not long-lived assets and, accordingly, should be evaluated for impairment consistent with other prepaid service costs.

Question 6: *Do you agree with the disclosures included in the proposed amendments? If not, what additional disclosures do you recommend, or what disclosures should be removed and why?*

Response: We do not believe that it is appropriate to propose new disclosure requirements for internal-use software absent a comprehensive project to address the recognition and measurement of that asset. We would encourage the Board to make use of its Disclosure Framework in this regard.

Question 7: *Should the disclosures included in the proposed amendments be applied to internal-use software and hosting arrangements that include a software license? Why or why not?*

Response: See above.

Question 8: *Should an entity be permitted to elect prospective transition or retrospective transition? If not, please explain what transition method should be required and why. If an entity elects prospective transition, should the entity apply the transition requirements to each hosting arrangement, each module or component within a hosting arrangement, or costs of the hosting arrangement?*

Response: We believe that retrospective transition should be permitted. In addition, we believe that prospective transition should be permitted for costs incurred after the effective date. Because the costs involved could be pursuant to any number of contracts with service providers and actions of employees, hosting arrangements may involve multiple providers of software and hosting services. We do not believe prospective transition to new or modified arrangements will produce consistent or useful results.

Question 9: *Should an entity be required to provide the transition disclosures specified in the proposed amendments? If not, please explain what transition disclosures should be required and why.*

Response: We believe the transition disclosures proposed in paragraph 350-40-65-3 (e) through (g) are consistent with disclosures generally provided in connection with the adoption of a new accounting principle.

Question 10: *How much time would be needed to implement the proposed amendments? Should early adoption be permitted? Do entities other than public business entities need additional time to apply the proposed amendments? Why or why not?*

Response: We are not in a position to assess the time required to adopt a new accounting standard. However, we believe entities should be permitted to early adopt new standards that improve financial reporting.

Question 11: *Should the proposed amendments be more broadly applied to similar transactions beyond hosting arrangements or be limited to transactions based on the scope of the proposed amendments? If more broadly applied, what transactions are similar to those included in the scope of the proposed amendments?*

Response: We believe the Proposed ASU should be redrafted to address the accounting for software rights of use embedded in a service contract and the related software implementation costs.