

FINANCIAL ACCOUNTING SERIES



ACCOUNTING STANDARDS UPDATE

No. 2015-05
April 2015

Intangibles—Goodwill and Other— Internal-Use Software (Subtopic 350-40)

Customer's Accounting for Fees Paid in a
Cloud Computing Arrangement

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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CONTENTS

	Page Numbers
Summary	1–2
Amendments to the <i>FASB Accounting Standards Codification</i> ®	3–6
Background Information and Basis for Conclusions	7–10
Amendments to the XBRL Taxonomy	11

Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The Board is issuing the amendments in this Update as part of its Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of the financial statements.

Existing GAAP does not include explicit guidance about a customer's accounting for fees paid in a cloud computing arrangement. Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service, and other similar hosting arrangements. The Board heard from stakeholders that the absence of explicit guidance resulted in some diversity in practice as well as unnecessary costs and complexity for some stakeholders to evaluate the accounting for those fees.

The Board decided to add guidance to Subtopic 350-40, Intangibles—Goodwill and Other—Internal-Use Software, which will help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. The guidance already exists in the *FASB Accounting Standards Codification*[®] in paragraphs 985-605-55-121 through 55-123, but it is included in a Subtopic applied by cloud service providers to determine whether an arrangement includes the sale or license of software.

The amendments in this Update provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The guidance will not change GAAP for a customer's accounting for service contracts. In addition, the guidance in this Update supersedes paragraph 350-40-25-16. Consequently, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets.

What Are the Transition Requirements and When Are the Amendments Effective?

For public business entities, the Board decided that the amendments will be effective for annual periods, including interim periods within those annual periods,

beginning after December 15, 2015. For all other entities, the amendments will be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted for all entities.

An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. For prospective transition, the only disclosure requirements at transition are the nature of and reason for the change in accounting principle, the transition method, and a qualitative description of the financial statement line items affected by the change. For retrospective transition, the disclosure requirements at transition include the requirements for prospective transition and quantitative information about the effects of the accounting change.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–6. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Subtopic 350-40

2. Add the Master Glossary term *Hosting Arrangement* to Subtopic 350-40 as follows:

Hosting Arrangement

In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

3. Amend paragraph 350-40-15-4 and add paragraphs 350-40-15-4A through 15-4C, with a link to transition paragraph 350-40-65-1, as follows:

Intangibles—Goodwill and Other—Internal-Use Software

Scope and Scope Exceptions

> Transactions

350-40-15-4 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process, subject to Subtopic 985-20
- b. Software to be used in research and development, subject to Subtopic 730-10
- c. Software developed for others under a contractual arrangement, subject to contract accounting standards

- d. Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications.
- e. Software that a customer obtains access to in a **hosting arrangement** that does not meet the criteria in paragraph 350-40-15-4A.

350-40-15-4A The guidance in this Subtopic applies only to internal-use software that a customer obtains access to in a **hosting arrangement** if both of the following criteria are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

350-40-15-4B For purposes of the guidance in paragraph 350-40-15-4A(a), the term *without significant penalty* contains two distinct concepts:

- a. The ability to take delivery of the software without incurring significant cost
- b. The ability to use the software separately without a significant diminution in utility or value.

350-40-15-4C **Hosting arrangements** that do not meet both criteria in paragraph 350-40-15-4A are service contracts and do not constitute a purchase of, or convey a license to, software.

- 4. Supersede paragraph 350-40-25-16, with a link to transition paragraph 350-40-65-1, as follows:

Recognition

> Capitalization of Cost

350-40-25-16 ~~Paragraph superseded by Accounting Standards Update 2015-05. Entities often license internal-use software from third parties. Though Subtopic 840-10 excludes licensing agreements from its scope, entities shall analogize to that Subtopic when determining the asset acquired in a software licensing arrangement.~~

- 5. Add paragraph 350-40-65-1 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*

350-40-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and*

Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement:

- a. For public business entities, the pending content that links to this paragraph shall be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015.
- b. For all other entities, the pending content that links to this paragraph shall be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016.
- c. Early application of the pending content that links to this paragraph is permitted by all entities.
- d. The pending content that links to this paragraph may be applied either prospectively to all arrangements entered into or materially modified after the effective date or retrospectively.
- e. A public business entity that elects prospective transition shall disclose the following in the first interim period and annual period after the effective date:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The transition method
 - 3. A qualitative description of the financial statement line items affected by the change.
- f. A public business entity that elects retrospective transition shall disclose the following in the first annual period after the entity’s adoption date and in the interim periods within the first annual period:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The transition method
 - 3. A description of the prior-period information that has been retrospectively adjusted
 - 4. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item(s), and any affected per-share amounts for the current period and any prior periods, retrospectively adjusted
 - 5. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
- g. All other entities shall disclose the information in (e) and (f) for prospective transition or retrospective transition, as applicable, in the first annual period after the entity’s adoption date, unless the entity elects to early adopt the pending content that links to this paragraph in an interim period, in which case the entity also shall disclose that information in the interim periods within the first annual period after the entity’s adoption date.

6. Amend paragraph 350-40-00-1, by adding the following items to the table, as follows:

350-40-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Hosting Arrangement	Added	2015-05	4/15/2015
Public Business Entity	Added	2015-05	4/15/2015
350-40-15-4	Amended	2015-05	4/15/2015
350-40-15-4A through 15-4C	Added	2015-05	4/15/2015
350-40-25-16	Superseded	2015-05	4/15/2015
350-40-65-1	Added	2015-05	4/15/2015

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board is issuing the amendments in this Update as part of its Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of the financial statements.

Background Information

BC3. The Board decided to add guidance to Subtopic 350-40 to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service, and other similar hosting arrangements. The amendments in this Update provide a basis for evaluating whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a license to internal-use software, then the software license should be accounted for by the customer in accordance with Subtopic 350-40. A license to software other than internal-use software should be accounted for under other applicable GAAP (for example, software to be used in research and development should be accounted for in accordance with Subtopic 730-10, Research and Development—Overall). If a cloud computing arrangement does not include a software license, then the arrangement should be accounted for as a service contract.

BC4. Some cloud computing arrangements include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s). The amendments in this Update do not change GAAP for a customer's accounting for service contracts. However, because the amendments supersede paragraph 350-40-25-16, some entities' accounting for acquired software licenses will change. At present, because of the guidance in paragraph 350-40-25-16, some entities analogize to operating lease guidance in accounting for some software licenses (that is, even when the entity obtains a software license, it accounts for the arrangement as executory in nature). As a result of the amendments, all

software licenses in the scope of Subtopic 350-40 will be accounted for in the same manner, consistent with the accounting for other licenses of intangible assets.

BC5. The guidance added to Subtopic 350-40 in this Update already exists in the Codification, but it is included in a Subtopic applied by cloud service providers to determine when an arrangement includes the sale or license of software. The guidance is included in Subtopic 985-605, *Software—Revenue Recognition* (paragraphs 985-605-55-121 through 55-123). The Board decided to use language that is nearly identical to the guidance applied by cloud service providers in the amendments in this Update because the Board wanted to use language that already was applied in practice. The guidance applied by cloud service providers is understood and has been applied in practice for many years. FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, amended the Codification by moving the guidance applied by cloud service providers to determine whether an arrangement includes the sale or license of software to Subtopic 985-20, *Software—Costs of Software to Be Sold, Leased, or Marketed*.

BC6. The Board decided not to provide additional guidance on how to apply the concepts in paragraphs 350-40-15-4A through 15-4C because that guidance already is applied and understood in current practice. The Board concluded that there could be unintended consequences from amending or adding to that guidance that has existed for many years. The amendments in this Update are intended to align the customer's evaluation of whether it is obtaining a software license or, instead, a service in a cloud computing arrangement with the same evaluation undertaken by the provider. This Update is not intended to change GAAP for vendors.

BC7. The Board observed in redeliberations that some stakeholders wanted the scope of this Update to be expanded to address a customer's accounting for implementation, set up, and other upfront costs that often are incurred by customers entering into cloud computing arrangements. The activities that entities perform in conjunction with entering into a cloud computing arrangement include training, creating or installing an interface, reconfiguring existing systems, and capturing and reformatting data. The Board observed that to the extent a cloud computing arrangement transfers a software license, Subtopic 350-40 provides guidance on how to account for costs such as those resulting from training, data capture, and conversion activities. In deciding not to provide additional guidance on the accounting for upfront costs incurred by customers entering into cloud computing arrangements that do not transfer a software license to a customer, the Board noted that initial costs incurred in service arrangements are not unique to cloud computing arrangements. Consequently, the scope of that issue is much broader than the scope of this Update. The Board decided that the scope of this Update should not be expanded to address the range of implementation and set-up costs incurred by a customer in a cloud computing arrangement.

BC8. The Board decided to supersede paragraph 350-40-25-16 as part of this Update. The guidance in that paragraph requires an entity to analogize to Topic 840, Leases, when determining whether an asset is acquired in a license of internal-use software. The Board had previously proposed to supersede the paragraph in the 2013 proposed FASB Accounting Standards Update, *Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)*, but, instead, decided that it was appropriate to supersede the guidance as part of the amendments in this Update. The Board observed that licenses of internal-use software are one of many types of licenses and decided that the accounting for software licenses should not be different from the accounting for other licenses of intangible assets. The amendments in this Update provide clear guidance on whether a customer is obtaining a license as part of a cloud computing arrangement. If a customer is obtaining a software license, it should account for that license consistently with the acquisition of any other license of an intangible asset.

BC9. On August 20, 2014, the Board issued a proposed Accounting Standards Update, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, which proposed to add guidance to Subtopic 350-40 to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. The Board received 24 comment letters in response to the proposed Update. Overall, respondents agreed with adding guidance to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. Most of those respondents agreed that customers should determine whether or not a cloud computing arrangement includes a software license by applying the same guidance that cloud service providers apply to determine whether they are selling a license to software or, instead, providing a service.

Effective Date and Transition

BC10. The Board decided that the amendments in this Update should be effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015, and for all other entities for the first annual period beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016.

BC11. The Board decided to allow all entities to early adopt the amendments in this Update because the amendments represent an improvement to GAAP that should reduce costs and complexity for preparers that are customers in cloud computing arrangements.

BC12. The Board decided that an entity may elect retrospective or prospective transition. Under prospective transition, an entity should apply the guidance in this Update to all arrangements entered into or materially modified after the effective date. The Board decided that the benefits of retrospective transition may not justify

the costs because the effect of retrospective application is not expected to be significant for those entities that would change their accounting as a result of the amendments in this Update. However, the Board saw no reason to prohibit an entity from retrospectively applying the amendments because the amendments should improve comparability between the financial statements of different preparers.

BC13. The Board decided that if an entity elects prospective transition, then the entity should disclose the nature of and reason for the change in accounting principle, the transition method, and a qualitative description of the financial statement line items affected by the change. The Board decided that the benefits of requiring quantitative disclosure of the effect of the amendments would not justify the costs. The Board acknowledges that the amendments in this Update may result in some entities changing their accounting for cloud computing arrangements; however, the change is not expected to be significant for the minority of entities that are required to change their accounting. If an entity elects retrospective transition, then the entity should disclose the requirements for prospective transition and some quantitative information about the effects of the change.

Benefits and Costs

BC14. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC15. The amendments in this Update will reduce cost and complexity because the lack of explicit guidance about a customer's accounting for fees paid in a cloud computing arrangement causes some entities to incur costs to evaluate that accounting. In addition, the amendments in this Update for determining whether a cloud computing arrangement includes a software license is already applied and understood in practice by software vendors and cloud service providers.

BC16. The amendments in this Update will increase the consistency of accounting for cloud computing arrangements among entities.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*[®] in this Accounting Standards Update require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those changes, which will be incorporated into the proposed 2016 Taxonomy, are available for public comment through ASU Taxonomy Changes provided at www.fasb.org, and finalized as part of the annual release process starting in September 2015.