

March 19, 2018

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

Re: File Reference 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*

Dear Technical Director:

Thank you for the opportunity to comment on the 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”).

We support the Proposed ASU. We note that the Proposed ASU resulted from a project to “provide additional guidance on accounting for implementation costs incurred in a cloud computing arrangement that is considered a service contract, due to the diversity in practice”.¹

In our experience, an increasing number of software providers are requiring their customers to purchase subscription, cloud-based access to the exact same software that was once offered through traditional licenses. Existing U.S. GAAP² provides guidance on how companies that license software should account for the costs of acquiring and implementing that software. However, there is significant diversity in practice as to how a customer of a

¹ See [Project Update and Background](http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176169036486) section of the Project Update for *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* (EITF Issue No. 17-A) at http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176169036486.

² See primarily ASC 350-40, *Intangibles—Goodwill and Other—Internal-Use Software*.

cloud computing arrangement accounted for as a service contract should account for costs³ associated with implementing that type of arrangement.⁴

We believe that the Proposed ASU addresses this pervasive issue in a pragmatic manner.

We acknowledge that some may view the Proposed ASU to contain certain conceptual inconsistencies. For instance, in the alternative views presented in paragraphs BC20-BC26 of the Proposed ASU, some FASB Board members believe that implementation costs associated with a cloud computing arrangement accounted for as a service contract do not meet the conceptual definition of an asset, and therefore should not be accounted for as such. We disagree with that assertion. In many cases, the implementation costs associated with implementing a cloud-based arrangement can be many times larger than the hosting fees under the cloud arrangement. That significant upfront investment alone strongly suggests that a customer views these implementation costs as providing future economic benefits that it controls by virtue of having a right to use the provider's software under the cloud computing arrangement.

We also understand that some FASB Board members do not support the Proposed ASU due to a perceived inconsistency between the accounting for (a) the amount paid to acquire a software license, (b) the fees paid to access a cloud computing arrangement accounted for as a license, and (c) the fees paid to access a cloud computing arrangement accounted for as a service contract, as shown in the following table:

Acquisition of a Software License	Fees Paid in a Cloud Computing Arrangement Accounted for as a License	Fees Paid in a Cloud Computing Arrangement Accounted for as a Service Contract
Capitalize the amounts paid to acquire the license as an intangible asset	Take the present value of the future payments and capitalize as an intangible asset, with an offsetting liability recognized	Expense the fees as incurred (do not recognize an asset or liability)

In contrast, similar implementation costs associated with any of the three arrangements described above would be accounted for in exactly the same manner under the Proposed ASU.

³ Such costs might include interfacing the vendor's cloud-based systems with a customer's existing on-premise software or configuring the cloud computing software to meet the customer's specific needs.

⁴ Scott Ehrlich, President of Mind the GAAP, LLC, participated as a member of the EITF Working Group for EITF Issue No. 17-A. The Working Group met on January 27, 2017. At that meeting, many Working Group members shared their views on how they believed internal and external costs of implementing a cloud computing arrangement accounted for as a service should be accounted for under current U.S. generally accepted accounting principles. There was significant diversity in practice.

We understand this perceived inconsistency and would encourage the FASB Board to take on a research project to address the accounting for executory contracts in general. As service arrangements and other types of executory contracts continue to expand in volume, we believe that the FASB should evaluate whether right-of-use (or similar) assets, along with corresponding contract liabilities, should be recognized for these arrangements, consistent with the conclusions reached in Accounting Standards Update 2016-02, *Leases*. See our response to Question 11 at the end of this letter for additional information detailing our views.

Nonetheless, although there may be inconsistencies in the accounting for a software license versus different types of cloud computing arrangements, that remains an ancillary and broader issue. The Proposed ASU was the result of a narrow scope project to address the accounting for implementation costs in a cloud computing arrangement accounted for as a service contract, a growing and pervasive issue that needed immediate attention. The Proposed ASU meets that objective, and actually results in a consistent accounting model for implementation costs no matter whether the software is accessed through the cloud or through an on-premise license.

Again, we support the Proposed ASU. However, we do have feedback on several items in the Proposed ASU that we believe could be clarified or amended. These suggestions are discussed in the following section. Thereafter, we have provided responses to each of the 11 questions for which the FASB staff has asked for specific feedback.

Thank you very much for considering our comments. If you have any questions or require further information regarding the contents of this letter, please contact Scott Ehrlich, President and Managing Director of Mind the GAAP, at +1 (773) 732-0654 or by email at sehrlich@mindthegaap.com.

A. We Suggest that the FASB Take on a Separate Project to Revisit ASC Subtopic 350-40 in Light of Changes in How Software is Developed.

The amendments in the Proposed ASU would align the requirements for capitalizing implementation costs associated with a hosting arrangement with those incurred to develop or obtain internal-use software. All such implementation costs would be accounted for under ASC Subtopic 350-40. Again, we are supportive of this outcome, but would also note that the guidance in ASC Subtopic 350-40 is somewhat outdated. Many software development projects in today's environment do not follow the linear, three-step path described in ASC Subtopic 350-40 in developing internal-use software (i.e., preliminary project, application development, post-implementation stages). Instead, companies often use an "agile" software development methodology. This involves a series of "sprints" where programmers develop "minimally

viable products” (MVP); these MVP are then tested by user focus groups. In some cases, user groups will outright reject the MVP, and it is discarded. Sometimes, user groups will like elements of an MVP, which are then developed further while rejected portions are scrapped. Accordingly, it is sometimes difficult to ascertain whether an agile software development project has passed the preliminary project phase and has entered the application development stage. Moreover, many companies don’t have robust processes and systems to track the costs incurred by internal software engineers – or even external consultants – that relate to the different software development stages when an agile methodology is employed. Therefore, we would encourage the FASB to consider a separate project to refresh the accounting model in ASC Subtopic 350-40 to better align it with how software development activities occur in today’s environment.

B. We Suggest Replacing the Term “Amortization” in Paragraph 350-40-35-11.

In ASC 350-40-35-11, as well as in the header preceding that paragraph, we would suggest not using the term “amortization”. ASC 350-40-45-1 states that the derecognition of any capitalized costs should be presented in the same line item of the income statement as the fees for the related hosting arrangement. We understand that this presentation requirement is designed to prevent companies from trying to remove these costs when presenting non-GAAP metrics like earnings before interest, taxes, depreciation and amortization, or EBITDA. Hence, to have better linkage with the presentation requirements in ASC 350-40-45-1, we would suggest removing references to “amortization” in ASC 350-40-35-11 and the header preceding that paragraph. We would instead propose replacing the first sentence of ASC 350-40-35-11 with the following: “Implementation costs capitalized ... Service Contract Subsections of this Subtopic should be reduced on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which the entity expects to benefit from access to the hosted software. The offsetting reduction in the capitalized balance shall be presented in accordance with ASC 350-40-45-1.” Similarly, ASC 350-40-45-1 should be amended to avoid reference to the word “amortization”.

C. We Suggest Adding Implementation Guidance on How to Determine the Term of the Hosting Arrangement that is a Service Contract.

The Proposed ASU would require companies to derecognize the capitalized implementation costs over the *term* of the hosting arrangement. The term would include the noncancelable period of the arrangement plus periods covered by (1) an option to extend the arrangement if the customer is reasonably certain to exercise that option, (2) an option to terminate the arrangement if the customer is reasonably certain not to exercise the termination option, and (3) an option to extend (or not to terminate) the arrangement in which exercise of the option is in the control of the vendor. The determination of the term of the hosting agreement is therefore analogous to the guidance in ASC Topic 842, *Leases*. However, there is limited guidance in the Proposed

ASU⁵ around what is meant by the term “reasonably certain”. We would suggest including some implementation guidance in ASC Section 350-40-55 to help practitioners evaluate the factors discussed in ASC 350-40-35-14 in determining the term of the hosting arrangement.

For example, assume that a reporting entity enters into a hosting agreement accounted for as a service with HostCo. There are a number of vendors that provide this same service, but the reporting entity selected HostCo after an extensive due diligence process. Under the terms of the hosting agreement, HostCo will constantly push out new features and bug fixes as and when available; hence, the underlying software is not subject to the same obsolescence risks as if the entity had licensed functional software from the same vendor. Further assume that the reporting entity will be charged an upfront set-up fee of \$1,500,000, and an ongoing hosting fee of \$3,000,000 per annum, payable at the beginning of each year. The hosting arrangement is noncancelable (without significant penalty) for three years. It is renewable on a year-to-year basis indefinitely at the mutual option of both the reporting entity and HostCo at then-market rates. The reporting entity capitalized \$10,000,000 of implementation costs associated with building a feed between the hosted software and its own licensed ERP, as well as configuring the hosted software for its particular needs.

In determining the term of the hosting arrangement, we would suggest that the reporting entity would consider the following relevant factors in ASC 350-40-35-14:

- a. **Obsolescence:** As HostCo has agreed to update the hosted software continuously, this factor would suggest that the capitalized implementation costs would have a useful life of longer than the three-year noncancelable term of the contract.
- b. **Technology and Competition:** There are a number of vendors that provide this same type of hosted software, suggesting that the technology is somewhat stable. This could indicate that the capitalized implementation costs would have a useful life of longer than three years since the risk of obsolescence for the underlying software again appears relatively low. On the other hand, the useful life of the capitalized implementation costs might only be three years because the reporting entity has options to move to other vendors at the end of the contract term. At the same time, the number of competitors would likely keep fees in check – so although the renewal rate in the HostCo contract is dependent on market factors, it would not be expected that such hosting fees would increase so drastically relative to other service providers so as to make renewal unlikely.
- c. **Other economic factors:** Although there are a number of vendors that can provide similar cloud-based software, high “switching costs” could suggest that the useful life of the capitalized development costs is longer than the three-year noncancelable term of the contract.

⁵ See ASC 350-40-35-14. There is no implementation guidance proposed for ASC Section 350-40-55.

- a. **Significant implementation costs:** The reporting entity incurred \$10,000,000 of implementation costs, as well as paid a one-time \$1,500,000 upfront set-up fee to the hosting company. These fees are significant, especially relative to the \$3,000,000 per annum hosting fee. Accordingly, the significance of the implementation (and set-up) costs would be expected to have significant economic value for the reporting entity when the option to extend the hosting arrangement becomes exercisable.

Based on the analysis of the aforementioned factors, the lessee would be reasonably certain to exercise its option to extend the term of the hosting agreement. Moreover, since the lessor also has joint control over the option to extend the hosting agreement, ASC 350-40-35-12(c) would indicate that the term should consider the likely renewal periods as well. Judgment will be required to determine the number of periods the reporting entity is expected to renew the hosting contract and therefore the term over which the capitalized implementation costs should be derecognized.

It also might be helpful to include a derecognition principle within ASC 350-40-35-11, preceding the detailed accounting requirements. We note that corresponding guidance in ASC 350-40-35-5 states that the development/acquisition costs for software developed for internal use should be derecognized *over the asset's useful life*. We would suggest making a similar statement at the beginning of ASC 350-40-35-11 in the Proposed ASU; we believe that including this type of principle will help practitioners apply the specific requirements related to evaluating whether options are reasonably certain to be exercised and determining the period over which the capitalized implementation costs are derecognized.

D. Feedback on Specific 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?

Yes - based on our position outlined earlier, we agree that eligible implementation costs of a hosting arrangement that is a service contract should be capitalized using the guidance on internal-use software, recognized in profit or loss over the term of the hosting arrangement as defined in the Proposed ASU, and presented in the same line item in the statement of income as the fee associated with the hosting arrangement.

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?

We are supportive of the amendment to the definition of hosting arrangement in the Master Glossary. However, in the basis for conclusions, we would recommend mentioning that most cloud computing arrangements involve a “license”. That license, however, provides a right to “access and use” software hosted on the software provider’s (or a third-party vendor’s) own servers. To avoid confusion, however, between cloud computing arrangements accounted for as a software license versus those accounting for as a service contract, the Board decided to remove the phrase “the licensing of” from the definition of a hosting agreement, and instead to focus that definition on the means by which that software is obtained (i.e., through access and use, rather than through ownership or license of the underlying intellectual property).

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

We do not believe additional guidance is needed to determine whether the amendments in this Proposed ASU apply to arrangements that include a minor hosting arrangement. The Proposed ASU was the result of a limited scope project to address the accounting for implementation costs in a cloud computing arrangement accounted for as a service contract, a growing and pervasive issue that needed immediate attention. The Proposed ASU achieves this objective. The costs of trying to further refine the scope of this issue, and potentially delay its issuance beyond the end of this calendar year, would far outweigh the benefits of getting much needed guidance into the marketplace on an expeditious basis.

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

Please refer to our comments earlier in this letter (Item A on pages 3-4). We would recommend a research project to reconsider the capitalization parameters currently contained in ASC 350-40 to better align with how software development practice has evolved over time.

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?

No. We believe that an entity should apply the same impairment model to implementation costs of a hosting arrangement that is a service contract versus other software development costs capitalized under ASC 350-40. As both types of costs were capitalized under the same principles in ASC Subtopic 350-40, there is no conceptual basis to evaluate those costs differently when assessing for impairment.

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?

We are supportive of the proposed disclosure requirements but would suggest the following amendment. Specifically, we would separate ASC 350-40-50-2(c) into two separate disclosures:

- **The first disclosure could read: "The amount of implementation costs that were capitalized during the period, and the amount that were immediately expensed under this Subtopic or other Topics."**
- **The second disclosure could read: "A qualitative description of the nature of implementation costs that were immediately expensed as well as the implementation costs that were capitalized during the period."**

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?

Yes. The disclosures included in the Proposed ASU should be applied to internal-use software and hosting arrangements that include a software license. We believe that financial statement users would benefit from the information provided by those disclosures, no matter whether the costs related to software developed internally, hosting arrangements accounted for as a license, or hosting arrangements accounted for as a service contract.

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?

We are supportive of providing entities an accounting policy election to adopt the provisions of the Proposed ASU on a prospective or retrospective basis. Although adopting the guidelines on a retrospective basis would be preferable in our view, we believe that many companies may not have the historical records to retrospectively determine which costs of implementing a hosting arrangement accounted for as a service would be eligible for capitalization (especially in relation to internal costs). Therefore, entities should have the ability to adopt the Proposed ASU on a prospective basis if desired. If an entity is provided a choice of transition methods, we believe that the transition method selected should be applied consistently to all hosting arrangements within the scope of the Proposed ASU. We do not support “cherry picking” particular contracts, or modules within contracts, for prospective or retrospective application.

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.

An entity should be required to provide the transition disclosures specified in the Proposed ASU. We think that those disclosures will be helpful for a financial statement user’s understanding of how the Proposed ASU affects the financial condition and results of operations of the adopting entity.

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?

We believe that the Proposed ASU should be made effective as quickly as possible. We would suggest that public companies be required to adopt the new guidelines in fiscal years beginning after December 15, 2018, with private companies receiving a one-year extension. However, we would strongly support the ability for any company to early adopt the new guidelines.

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?

At this time, we would not support applying the principles in the Proposed ASU more broadly. We would instead prefer that the Board add a research project to its agenda to identify common types of executory contracts, and to ascertain whether implementation costs associated with those types of contracts are material. If so, we would then urge the Board to take on a full project of evaluating the accounting for executory contracts – i.e., whether assets and liabilities should be recognized for those contracts – with a corollary issue of whether implementation costs associated with those executory contracts should be capitalized (consistent with the analogous guidance in this Proposed ASU and in ASC Topic 842).