Cloud computing
Accounting considerations for software as a service

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What is cloud computing?

Cloud computing is essentially a model for delivering information technology services in which resources are retrieved from the internet through web-based tools and applications, rather than a direct connection to a server. Data and software packages are stored in servers. Cloud computing structures allow access to information as long as an electronic device has access to the internet. This type of system allows employees to work remotely. Cloud computing is so named because the information being accessed is found in the ‘clouds’, and does not require a user to be in a specific place to gain access to it. Companies may find that cloud computing allows them to reduce the cost of information management, since they are not required to own their own servers and can use capacity leased from third parties. Additionally, the cloud-like structure allows companies to upgrade software more quickly.

There are various types of cloud computing arrangements. Cloud services usually fall into one of three service models: infrastructure, platform and software. In this publication, we focus on software as a service (SaaS).

What is SaaS?

SaaS is a software distribution model in which the customer does not take possession of the supplier’s hardware and application software. Instead, customers accesses the supplier’s hardware and application software from devices over the internet or via a dedicated line. In these types of arrangements, the customer does not manage or control the underlying cloud infrastructure, including the network, servers, operating systems, storage, and even individual application software capabilities, with the possible exception of limited user-specific application software configuration settings, nor is the customer responsible for upgrades to the underlying systems and software.

What are the key issues to consider?

In practice, we have observed various application issues relating to the customer’s accounting in SaaS arrangements. These arrangements may often be bundled with other products and services, such as implementation, data migration, business process mapping, training, and project management.

For simplicity, this publication only focuses on accounting for arrangements for the customer’s access to hardware and application software and, more specifically, on fees paid to the supplier for the customer’s access to the supplier’s application software.

The key accounting issues identified with these arrangements arise as result of a change in the business model. The original business model, before the implementation of SaaS, involved an entity using its own servers and applications, resulting in the recognition of property, plant and equipment as well as intangible assets on the entity’s balance sheet. Under the new business model, SaaS, there is the possibility of recognising these cash flows as operating expenses. This is illustrated by the examples on the following pages.
PwC observation

It is recommended that companies should provide information to investors to assist them in understanding that although the change in the business model could result in different accounting that has an impact on profit and loss and the balance sheet, there is no fundamental change to the company’s business.

International Financial Reporting Interpretations Committee (IFRIC) discussion

The Committee received a request about a customer’s accounting for SaaS arrangements. Specifically, the request asked how a customer applies IAS 38 Intangible Assets and IFRS 16 Leases in accounting for fees paid to access the supplier’s application software running on the supplier’s cloud infrastructure. This was discussed during the September 2018 meeting. Tentative observations from this meeting are included below.

Examples

Example 1

Entity A enters into a three-year non-cancellable contract to obtain the use of software that is stored in the cloud, including various applications for that period (services) from a supplier. Entity A will be required to pay a fixed monthly subscription fee.

The software is not specifically customised for Entity A’s purpose and is an off-the-shelf software package that is available on a subscription basis or for purchase by any other user.

Entity A does not acquire the right or licence to use the services for more than the three-year contract period and at the end of the contract period, the right to access and use the service shall terminate.

The supplier has no obligation for delivery of the software program and will not ship copies of the program to Entity A. The supplier, or its licensors, retain all ownership and intellectual property rights to the services, including the programs and ancillary software, including anything developed or delivered in terms of the agreement.

In the event that the subscription fee is not paid, the software goes into reduced functionality mode. In this mode, users can open and view existing files, but cannot use a majority of the other features of the software.

Does the arrangement meet the definition of a lease under IFRS 16?

Under IFRS 16, an arrangement is, or will contain, a lease if there is an identified asset and the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

The scope of IFRS 16 excludes rights held by a lessee under licensing agreements within the scope of IAS 38, for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
PwC observation: The arrangement for the right to access the supplier’s software does not contain a lease in terms of IFRS 16.

Entity A does not acquire the right or license to use the supplier’s application software for more than the three years in terms of the service contract. Furthermore, the supplier/its licensors, retain all ownership and intellectual property rights to the supplier’s application software.

The arrangement will therefore not meet the criteria to be classified as a lease in terms of IFRS 16 as Entity A is not able to control the use of an identified asset.

IFRIC tentative observation: Rights to access the supplier’s software are within the scope of IAS 38 but not IFRS 16

All leases of software would result in rights being held by a lessee under a licensing arrangement. The scope exclusion of IFRS 16 therefore covers all software licensing agreements and, thus, an entity should account for all rights to access or use the application software by applying IAS 38, not IFRS 16.

Can the monthly subscription fee be capitalised as an intangible asset?

In terms of IAS 38, an intangible asset is “an identifiable non-monetary asset without physical substance” which has the following key characteristics: identifiability, control over a resource, existence of future economic benefits and a lack of physical substance.

IAS 38 further explains that control involves having the power to obtain future benefits and to restrict the access of others to those benefits.

PwC observation: The subscription service fee cannot be capitalised as an intangible asset in terms of IAS 38.

Entity A does not have control over the software, as simply having a right to access the supplier’s application software would not be sufficient to indicate that Entity A, at contract inception, controls a resource that meets the definition of an intangible asset. Entity A has therefore not determined circumstances in which the fee should be capitalised as an intangible asset due to the lack of control.

How should the arrangement be accounted for by Entity A?

PwC observation: The subscription service fee should be expensed as incurred.

As the arrangement fails the criteria to be classified as a lease in terms of IFRS 16 and fails to meet the criteria to be capitalised as an intangible asset under IAS 38, the arrangement is considered to be an executory service contract. The subscription fees should therefore be expensed as the related service is provided.
Assume the same fact pattern as Example 1 except that the software is specifically customised for Entity A’s purpose, which requires significant configurations and is not ‘off-the-shelf’ software. Entity A will have to incur the costs for designing and configuring the cloud-based accounting suite to be specific to the needs of Entity A. Entity A therefore pays an upfront fee for this customization.

Would this lead to a different answer than that specified in example 1?

**PwC observation**

For the same reasons set out in Example 1, the arrangement will fail to meet the requirements to be classified as a lease in terms of IFRS 16 as well as the criteria to be classified as an intangible asset in terms of IAS 38.

The substance of the arrangement is that Entity A pays an upfront fee (i.e. prepays) to customise/configure the software that is stored on a cloud.

**IFRIC tentative observation**

There is currently diversity in views among Committee members in terms of the classification of application software as an intangible asset under IAS 38, where there is significant configuration or customisation of the application software.

One view is that where there is significant configuration, the software is regarded as an asset that the customer controls, just as in a situation where the software is downloaded onto the customer's computer and the customer can run it independently.

An alternative view is that customisation may not be a key indicator of control because the supplier can license it to others even though the supplier provided a highly customised software.

No decisions or conclusions have been reached by the IFRIC on this matter.

**Note:** In terms of IAS 38, an entity can recognise a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods and, similarly, when payment for services has been made in advance of the entity receiving those services. An entity will, however, not be entitled to recognise an asset beyond the point at which the entity received the related services.

**PwC observation: The monthly subscription fee paid upfront could be recognised as a prepaid asset.**

Entity A can recognise the monthly subscription fee paid upfront as a prepaid asset until the point that Entity A has received the related services.
Watch this space

Software as a service (SaaS) and cloud computing arrangements are topics that are currently evolving in practice and views on the accounting treatment of such arrangements may continue to develop in the future.

Global outreaches are currently being conducted to establish the following information:

- Whether SaaS cloud computing arrangements are common;
- How such arrangements are accounted for under current IFRS; and
- Whether this accounting is likely to be affected by the new IFRS Standards that have been issued, but are not yet effective.

SaaS has recently been considered by the Financial Accounting Standards Board (FASB) and the International Financial Reporting Interpretations Committee (IFRIC), and as a result, this may be something that the International Accounting Standards Board (IASB) a) might similarly consider in the future.

Find out more

PwC clients who have questions about this publication should speak to their engagement partner.

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