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Advisor Alert

ASPE and ASNPO - New accounting guideline for cloud computing arrangements

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Private enterprises and not-for-profit organizations (NPOs) are increasingly entering into more cloud computing arrangements due to a rise in technological developments and demand for remote access. As a result, customers have been asking for specific guidance on how to account for their expenditures and identify any related software intangible assets.

A new Accounting Guideline (AcG-20) *Customer's Accounting for Cloud Computing Arrangements* (Guideline) came into effect for fiscal years beginning on or after January 1, 2024. The Guideline provides new accounting requirements that apply to both private enterprises applying Accounting Standards for Private Enterprises (ASPE) and NPOs applying Accounting Standards for Not-for-Profit Organizations (ASNPO). It can be found in Part II of the CPA Canada Handbook – Accounting. This publication summarizes the key requirements of the new Guideline and provides some practical insights on how entities may be impacted.

We'll cover:

- What is a cloud computing arrangement?
- Why a new Guideline?
- Initial recognition and measurement of the cloud computing arrangement
- Tangible elements
- Simplification approach to account for a cloud computing arrangement
- Recognition of the software element as an intangible asset
- Recognition of the software element as a service (expense)
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What is a cloud computing arrangement?

Cloud computing arrangements are the on-demand delivery of computing resources (e.g., software, servers, data storage, networking infrastructure) over the internet or a private network. There are various deployment models for delivering the computing resources, such as cloud-based, on-premises, or in a hybrid environment.

Entities can subscribe to any or all of software, platform, or infrastructure as a service. For example, more entities are shifting towards a software as a service (SaaS) arrangement (i.e., paying a subscription fee to access software in a vendor's cloud environment, rather than purchasing the full software license). There may be multiple elements within a single cloud computing arrangement, such as software, hardware, and implementation activities.

Why a new guideline?

The new Guideline provides clarity in areas such as:

- How to determine if the cloud computing arrangement contains any assets to recognize, such as intangible assets or prepaid expenses, especially in relation to implementation costs (which can be a substantial expenditure for many entities).
- How to account for subsequent changes to the software in a cloud computing arrangement (e.g., upgrades or additional modules).
- What disclosures are appropriate to explain cloud computing arrangements and their impacts on the financial position, operations, and cash flows of an entity.

The Guideline also provides clarity and accounting policy choices to help entities convey the multi-year economic benefit that may result from significant expenditures to implement a cloud-computing solution. For software received as a service (also referred to as a software service), the contractual right

obtained by the entity is often the right to access the vendor's software, rather than the right to control the vendor's software itself. As a result, many entities had difficulty achieving asset treatment for any implementation costs incurred related to the software service, resulting in those costs being expensed.

Initial recognition and measurement of the cloud computing arrangement

At inception of the cloud computing arrangement, the entity (or "customer") must allocate the consideration to its significant separable elements (e.g., hardware, licensing the software/subscription to access the software, and in some cases, implementation activities). Factors to consider when determining whether a software element is separable from the implementation activities include whether:

- the vendor sells the software license/subscription to other customers separately from the implementation activities, or
- only the vendor or the vendor's subcontractor is capable of performing the implementation activities.

The entity must allocate the consideration to the various significant separable elements on a rational and consistent basis. While the Guideline doesn't prescribe an allocation method, entities can look to the suggested methods in Section 3400 *Revenue*.

Tangible elements

The Guideline doesn't address the accounting for tangible elements in a cloud computing arrangement, such as expenditures on property, plant and equipment or a right to use a tangible capital asset. Entities should refer to Section 3061 *Property, plant and equipment* / Section 4433 *Tangible capital assets held by not-for-profit organizations* or Section 3065 *Leases*, as appropriate.

Simplification approach to account for a cloud computing arrangement

Entities can use a simplification approach to account for expenditures in a cloud computing arrangement (other than tangible elements). In this approach, expenditures are treated as the supply of services and expensed as incurred.
A prepayment for the delivery of the service would be recognized as an asset (i.e., prepaid expense), if an advance payment has been made.

The simplification approach is an accounting policy choice that must be applied consistently to expenditures in **all** cloud computing arrangements. It's not an arrangement-by-arrangement choice. An entity that doesn't apply this approach must determine if a software element is a software intangible asset or a software service (see next section).

Practical insight
The simplification approach reduces accounting complexity and cost, as the entity doesn't have to:

- assess if there are any intangible assets to recognize in the arrangement, or
- analyze the appropriate accounting for individual implementation costs (other than those related to tangible elements).

Recognition of the software element as an intangible asset

Entities that don't elect the simplification approach must assess whether there's a software element that must be recognized as an intangible asset. For this assessment, the entity would refer to the guidance in Section 3064 *Goodwill and intangible assets* which requires the recognition of an intangible asset for an element that:

- is identifiable
- is controlled by the entity, and
- has future economic benefits that flow to the entity.

A software element is generally identifiable because it arises from contractual rights, and would have future economic benefits that flow to the entity from the use of the software.
For the second criterion, the Guideline conveys that a software element is controlled by the entity if it meets **both** of the following conditions:

- it has the contractual right to obtain the software without significant penalty (i.e., the ability to take delivery of the software without incurring significant cost), and
- it can use the software separately without a significant reduction in utility/value, and it is feasible for the entity to run the software on its own or on a third party's infrastructure.

The entity may control the software element based on other factors such as, but not limited to:

- exclusive rights to use the software or ownership of the intellectual property for customized software (i.e., the vendor cannot make the software available to other customers), or
- decision-making rights to change how and for what purpose the software is used throughout the period of use (e.g., the entity can decide on how and when to update or reconfigure the software).

Recognition of the software element as a service (expense)

For a software element in the arrangement that doesn't meet the definition of an intangible asset, it's accounted for as a service (also referred to as a "software service"). When an entity pays a subscription fee to access software which doesn't meet the definition of an intangible asset, the consideration allocated to the software service must be expensed as incurred.

Implementation costs

Many entities incur substantial implementation costs as part of their cloud computing arrangements. For example, entities may incur integration, customization or coding, configuration, data conversion, testing, training, and/or business process reengineering expenditures.

For entities that elect the simplification approach, expenditures in a cloud computing arrangement (other than tangible elements) are expensed as incurred, which includes implementation costs. For entities that **do not** elect the simplification approach, the new Guideline provides entities with an accounting policy choice to either capitalize or expense certain implementation costs related to a software service. This accounting policy choice must be applied consistently to the software services in **all** of the entity's cloud computing arrangements.

Implementation costs related to other elements in the arrangement may still need to be expensed or capitalized depending on their nature.

This table summarizes the accounting treatment for implementation costs when an entity does not elect the simplification approach:

	Type of implementation expenditures	Accounting treatment
1	Expenditures directly attributable to preparing a **software intangible asset** for its intended use	Capitalize the expenditures as part of the cost of the asset. Subsequently, the software intangible asset is amortized and tested for impairment in accordance with Section 3064 *Goodwill and intangible assets.*
2	Expenditures that give rise to a separate **intangible asset**	Account for the expenditures in accordance with Section 3064 *Goodwill and intangible assets*. For example, the expenditures to develop software code may give rise to an internally-generated intangible asset which is accounted for in accordance with the entity's accounting policy choice for internally-generated intangible assets.
3	Expenditures to implement **software that is accounted for as a service** (i.e., a software service that is expensed as incurred)	Accounting policy choice to either: a. Expense the expenditures; or b. Capitalize expenditures that are directly attributable to preparing the software service for its intended use as a separate asset on the balance sheet. The capitalized expenditures are expensed using a straight-line method over the expected period of access to the software service unless another method better reflects the pattern in which the enterprise expects to benefit from accessing the software. There are numerous factors that should be considered in determining the expected period of access to the software service, such as: • expectations regarding the length of time that the entity plans to continue accessing the software service, provided there is evidence to support those expectations • non-cancellable periods, renewal periods or termination clauses provided there is reasonable assurance of the execution of such clauses • the effects of obsolescence, technology, competition, and other economic factors that may limit the expected period of access to the software service by the entity. The method of amortization and the expected period of access to the software service must be reviewed on a regular basis. The capitalized amounts are tested for impairment in accordance with the related Handbook Sections (i.e., Section 3063 *Impairment of long-lived assets* (private enterprises) or Section 4434 Intangible assets *held by not-for-profit organizations* (not-for-profit organizations).
4	Expenditures that are not directly attributable to preparing the **software intangible asset** or **software service** for intended use	Expense as incurred (e.g., research and training activities).

An entity may incur subsequent expenditures to enhance the service potential of the software after the initial implementation of the software element. Service potential may be enhanced when there is an increase in the previously assessed service capacity, an extension of the useful life or the expected period of access to the software service, or an improvement in the quality of the output. When this occurs, the expenditures that are directly attributable to enhancing the service potential of:

- a software intangible asset— are added to the carrying amount of the software intangible asset
- a software service— are included in the carrying amount of any implementation cost asset that was recognized (see item 3b in the previous table). Maintenance activities must be expensed as incurred.

Presentation

Entities must present any software intangible assets, along with any directly attributable expenditures on implementation activities, in accordance with Section 3064 *Goodwill and intangible assets*. The cash flows are classified under investing activities in the statement of cash flows.

Implementation costs associated with software services that the entity has elected to capitalize as an asset must be presented as a separate asset on the balance sheet. Generally, this asset is presented as a long-term asset, unless the expected term of access to the software service is less than one year from the balance sheet date, or within the normal operating cycle of the entity (when it is more than a year). The expensing of the implementation costs asset is included in the same line item in the income statement as the subscription fees expense for the software service. The cash flows are classified as operating activities in the statement of cash flows.

Disclosure

An entity that applies the simplification approach must disclose that fact, the amount expensed for the period, and where it was included in the income statement.

An entity that doesn't apply the simplification approach must disclose the following for a software service:

- The amount expensed for the period and where it is included in the income statement;
- The policy followed to account for expenditures that are directly attributable to implementing the software service;
- If implementation expenditures directly attributable to a software service are capitalized, the net carrying amount capitalized and the method used to expense the amount, including the expected period of access to the software service by the entity; and
- For any impairment loss recognized, the amount of the impairment loss, where the impairment loss is included in the income statement, and the facts and circumstances leading to the impairment.

The entity would also need to disclose any commitments in accordance with Section 3280 *Contractual obligations*.

Transition

The Guideline applies to fiscal years beginning on or after January 1, 2024, with earlier application permitted. A choice must be made to apply the standard either retrospectively or retrospectively only to expenditures on implementation activities incurred in a cloud computing arrangement on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the Guideline. If the entity applies this transitional provision, it must disclose that fact. It's also required to apply the Guideline retrospectively to any previously recognized assets resulting from a cloud computing arrangement with any adjustment to those assets recorded in opening retained earnings of the earliest period presented.

Our thoughts

This new Guideline clarifies the accounting, especially related to implementation costs, for entities that enter into cloud computing arrangements. For entities that want to reduce their accounting costs and burden, they should elect the simplification approach. For entities that wish to better convey the future benefits provided by their expenditures, they can opt not to elect the simplification approach, capitalize any intangible assets, and choose to capitalize certain implementation costs to better convey the expected period of benefit in their income statement. These accounting policy choices must be applied consistently to all of the entity's cloud computing arrangements.

How can Grant Thornton help?

At Grant Thornton, our advisors are up to date on AcG-20 and can help enterprises interpret the guidance, assess the impact on their financial statements and determine what information the enterprise needs to gather in advance of applying the new requirements for the first time.

Please reach out to your Grant Thornton advisor if you have any questions.

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