Accounting for Configuration and Customisation Costs in a Software as a Service Arrangement

Impact of the April 2021 Agenda Decision published by the IFRS Interpretations Committee

Introduction

Agenda decisions are published when the IFRS Interpretations Committee decides that a standard-setting project should not be added to the IASB's Work Plan in response to an IFRS® application question received. In many cases, agenda decisions include *explanatory material* that explains how the applicable principles and requirements in IFRS Standards apply to a specific transaction or fact pattern.

Agenda decisions with explanatory material are published to help support the understanding and consistent application of IFRS Standards. In New Zealand, our for-profit standards (NZ IFRS) as issued by the External Reporting Board (XRB) are based on IFRS Standards.

The IFRS Interpretation Committee in April 2021 published an agenda decision on Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets) (the 'April 2021 Agenda Decision').

We are aware that this agenda decision is requiring many reporting entities in New Zealand to reconsider whether they have appropriately accounted for the costs of configuring and customising software provided by a supplier through a cloud-based computing arrangement – described as a SaaS arrangement. This reconsideration may result in changes to how applicable costs have been accounted for in the current and previous reporting periods, especially when significant configuration or customisation costs have been capitalised as intangible assets.

The Q&As provide XRB Staff responses to some of the common questions arising from the application of the April 2021 Agenda Decision.

Do I need to apply the explanatory material in agenda decisions?

The IFRS Foundation's standard-setting manual – the Due Process Handbook (updated August 2020) confirms the status of agenda decisions.

> *In many cases, agenda decisions include explanatory material that explain how the applicable principles and requirements in IFRS Standards apply to the transaction or fact pattern described in the agenda decision. Explanatory material derives its authority from the Standards themselves (the explanatory material cannot add or change requirements in IFRS Standards). Accordingly, an entity is required to apply the applicable IFRS Standard(s), reflecting the explanatory material in an agenda decision (subject to it having sufficient time to implement that accounting).*

The updates to the IASB's Due Process Handbook confirm that agenda decisions cannot add or change requirements in IFRS Standards, but rather aim to improve consistency in their application. The explanatory material in an agenda decision derives its authority from the IFRS Standards and often provides additional insights on how to apply them. Therefore, reporting entities are expected to change their accounting policy to the extent that their accounting differs from that described in an agenda decision.

As discussed below, for-profit entities and public benefit entities (PBEs) have <u>different</u> requirements when it comes to considering applicable explanatory material in agenda decisions when applying NZ IFRS and PBE Standards as issued by the External Reporting Board (XRB).

For-profit entities

When preparing NZ IFRS compliant financial statements, an entity is required to apply applicable NZ IFRS Standards, giving consideration to any related explanatory material in agenda decisions published at the reporting date — subject to having sufficient time to consider the explanatory material and action any required changes to its accounting policies.

Agenda decisions do not add or change the requirements in the NZ IFRS Standards, but any explanatory material included may provide new information on how to apply a standard(s) for a specific transaction or fact pattern. Consideration of this new information may lead to an entity changing the way it accounts for certain transactions in its financial statements.

PBEs — Public Sector and NFP entities

Agenda decisions are specifically developed with for-profit entities in mind. However, PBEs (public sector or not-for-profit entities) <u>may</u> also consider applicable agenda decisions when developing their accounting policies.

In the absence of a PBE Standard that specifically applies to a transaction, other event, or condition, management shall use its judgement in developing an appropriate accounting policy in accordance with PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors.*

The PBE Standards do not include specific guidance on the accounting for configuration and customisation costs associated with SaaS arrangements. Therefore, Tier 1 and Tier 2 PBEs will be required to consider the requirements and guidance in PBE IPSAS 3 when determining how to account for these transactions.

In making this judgement, management shall consider:

(a) The requirements in PBE Standards dealing with similar and related issues; and

(b) The definitions, recognition and measurement criteria for assets, liabilities, revenue and expenses described in the Public Benefit Entities' Conceptual Framework.

When forming these judgements, management may also consider the most recent pronouncements of other standard-setting bodies, including applicable explanatory material in agenda decisions issued by the IFRS Interpretation Committee.

What issues are considered by the April 2021 Agenda Decision?

The key issue addressed by the April 2021 Agenda Decision is whether the cost of configuring or customising a supplier's application software in a SaaS arrangement should be capitalised as an intangible asset or expensed as a service contract by the reporting entity (the customer).

In SaaS arrangements as described by the agenda decision, the customer receives a right to access the supplier's software over the contract period, and does not recognise the software itself or the right to access it as an intangible asset (because the supplier retains control over the software).

The April 2021 Agenda Decision considered two key questions:

(a) Whether, applying IAS 38 *Intangible Assets*, the customer recognises an intangible asset in relation to configuration or customisation of the application software; and

(b) If an intangible asset is not recognised, how the customer accounts for the configuration or customisation costs.

In response to these questions, the Interpretations Committee concluded that the existing principles and requirements in the IFRS Standards provide an adequate basis for an entity to determine how to account for configuration or customisation costs incurred when putting in place SaaS arrangements.

However, the Agenda Decision includes explanatory material on how to apply the applicable principles and requirements in IFRS Standards when accounting for configuration or customisation costs associated with SaaS arrangements for the fact pattern described in the agenda decision.

The explanatory material reflects existing IFRS requirements and therefore does not change the existing requirements and principles in IAS 38 *Intangible Assets* and/or other applicable IFRS Standards.

The new information provided in the explanatory material may change how an entity currently accounts for configuration or customisation costs associated with SaaS arrangements.

For further discussion on the explanatory material, we suggest referring to the April 2021 Agenda Decision itself.

What is a SaaS arrangement?

SaaS arrangements are becoming increasingly common and are used by many organisations across New Zealand and around the world. SaaS arrangements provide an entity with the right to access a supplier's application software over the cloud (i.e. via the internet), but the entity (the customer) has no ownership rights over the software.

Common examples are email, calendar, and office tools (such as Microsoft Office 365). SaaS arrangements typically provide a software solution that an entity purchases on a pay-as-you-go basis from a cloud-based service provider.

SaaS arrangements differ from traditional on-premises software licensing arrangements in the following ways:

(a) The service software is not installed or stored on the customer's computer systems;

(b) The software infrastructure is managed by the SaaS provider (or another third party);

(c) Access is provided to multiple customers;

(d) Service customisation is often limited and any software configuration is largely available to all customers;

(e) The provider maintains full ownership and control of the software and is responsible for maintenance and support; and

(f) Service fees accrue and payable on a recurring, periodic basis.

Whether you have a SaaS arrangement as considered by the April 2021 Agenda Decision will require professional judgment based on the terms and conditions of the arrangement and the fact pattern described in the agenda decision.

What are configuration and customisation costs?

As described in the April 2021 Agenda Decision:

Configuration involves the setting of various 'flags' or 'switches' within the application software, or defining values or parameters, to set up the software's existing code to function in a specified way.

Customisation involves modifying the software code in the application software or writing additional code. Customisation generally changes, or creates additional, functionalities within the supplier's software.

What is the potential accounting impact of the April 2021 Agenda Decision?

Current accounting treatment

Reporting entities who enter cloud-based computing arrangements often incur significant upfront implementation costs. For SaaS arrangements, we understand that many reporting entities are currently capitalising the costs associated with configuring or customising supplier's application software so that it can be used as intended by the reporting entity.

The accounting practice of capitalisation has arisen from the view that the customisation and configuration costs incurred in setting up SaaS arrangements provide future benefits to the reporting entity beyond the period in which the costs are incurred. These capitalised costs are therefore recognised as intangible assets in the statement of financial position.

Accounting impact of agenda decision

The explanatory material in the April 2021 Agenda Decision will require entities that have previously capitalised significant configuration and customisation costs associated with SaaS arrangements to reconsider these previous decisions.

In some cases (but not all) where significant configuration and customisation costs associated with SaaS arrangements have been capitalised, intangible assets recognised may need to be derecognised and removed from the balance sheet.

Extract from April 2021 Agenda Decision

In the fact pattern described in the request, the supplier controls the application software to which the customer has access. The assessment of whether configuration or customisation of that software results in an intangible asset for the customer depends on the nature and output of the configuration or customisation performed. The Committee observed that, in the SaaS arrangement described in the request, the customer often would not recognise an intangible asset because it does not control the software being configured or customised and those configuration or customisation activities do not create a resource controlled by the customer that is separate from the software. In some circumstances, however, the arrangement may result in, for example, additional code from which the customer has the power to obtain the future economic benefits and to restrict others' access to those benefits. In that case, in determining whether to recognise the additional code as an intangible asset, the customer assesses whether the additional code is identifiable and meets the recognition criteria in IAS 38 Intangible Assets.

Whether configuration and customisation costs associated with SaaS arrangements should be capitalised or expensed as a service contract will require the application of the applicable IFRS Standard(s) together with consideration of the new information provided in the agenda decision explanatory material. Professional judgment will be required based on all the facts and circumstances of the transaction.

Reporting a change in accounting treatment

Any material change in accounting resulting from an agenda decision should be accounted for in accordance with NZ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

If an entity's application of IFRS Standards in previous periods is inconsistent with the explanatory material in an agenda decision, this does not immediately indicate an error – unless the inconsistency relates to a failure to appropriately consider the information that was available when the financial statements were authorised for issue.

The explanatory material in agenda decisions represents new information that was not known when the decision was made to capitalise any configuration and customisation costs associated with SaaS arrangements in prior periods. Any change in the accounting treatment, as a result of an agenda decision, is therefore generally accounted for as a voluntary change in accounting policy and must be applied retrospectively.

A change in accounting policy means adjustments may be required to the prior year comparative information in accordance with NZ IAS 8 requirements. Any costs capitalised with respect to SaaS arrangements in prior years may need to be adjusted against the entity's opening retained earnings for the comparative year.

For-profit Tier 1 entities will be required to present a third balance sheet, as at the beginning of the comparative period, when there are material retrospective adjustments that affect the financial position at the start of the comparative period.

Please also refer to the questions below for a further discussion on *when* and *how* a change in accounting resulting from an agenda decision would be reflected in the financial statements:

- When is the April 2021 Agenda Decision Effective?
- What is the impact of applying an agenda decision when published or in the subsequent reporting period?

When is the April 2021 Agenda Decision Effective?

Sufficient time

New accounting standards or amendments to accounting standards, when issued, typically have an effective date that allows 2-3 years for an entity to apply the new reporting requirements. In contrast, agenda decisions do not have an effective date or any transition provisions. Any explanatory material in an agenda decision is therefore in principle expected to be applied with immediate effect.

However, in practice, it is recognised that implementing agenda decisions may sometimes be difficult – especially when an agenda decision is issued near a reporting date. The IASB confirmed in December 2018 that it expects a reporting entity to be entitled to "sufficient time" to determine whether to change an accounting policy as a result of an agenda decision and to implement any such change (i.e. calculate the accounting impact from the start of the comparative year).

What is meant by "sufficient time" will require the application of professional judgment and will depend on the particular facts and circumstances. Consideration should be given to the materiality, volume, and complexity of the transactions in question.

In March 2019 Sue Lloyd, Chair of the IFRS Interpretations Committee, clarified in an IASB article that:

> *Once an agenda decision is finalised it becomes a relevant piece of information in applying IFRS Standards. Explanatory material set out in agenda decisions, in essence, affirms the application of existing requirements. Therefore, companies need to consider agenda decisions and implement any necessary accounting policy changes on a timely basis – in other words, as soon and as quickly as possible.*

For further guidance on what is meant by "sufficient time" we suggest referring to the full IASB article Agenda decisions – time is of the essence.

Time required to assess the April 2021 Agenda Decision

When considering what "sufficient time" represents when considering the April 2021 Agenda Decision, the time required includes the assessment of whether the new information in the agenda decision results in the need for a change in accounting policy and also the time required to implement any required changes to the current and previous years reported amounts.

Where a change in accounting policy is deemed to be required, sufficient time will be needed to implement the change, including:

(a) Identifying and reviewing the terms and conditions of SaaS arrangements entered into over current and previous reporting periods;

(b) extracting associated customisation and configuration costs incurred in the current and previous periods; and

(c) introducing new systems and processes (and controls) to capture the information required to apply the new accounting policy.

Dependent on the extent to which customisation and configuration costs have been capitalised in pervious reporting periods and the complexity of SaaS arrangements, a change in accounting policy may require more time to ensure appropriate accounting outcomes are achieved.

Sufficient time will be required to apply a change in accounting policy resulting from an agenda decision, to ensure that any amendments arising from the change provides for information that faithfully represents the effects of the transactions and provides useful, complete, and reliable information.

Allowing for sufficient time, in certain circumstances, may mean that the assessment of the financial impact of a change an accounting policy is completed and reflected in the subsequent reporting period – discussed further in the next section.

The Chair of the Interpretation Committee in March 2019 noted that the overarching goal in allowing for sufficient time is for everyone involved in the financial reporting *"to work together to ensure that an appropriate outcome is achieved and that collectively we work towards the goal of high-quality, consistent application of IFRS Standards*".

Professional judgement will be required.

What is the impact of applying an agenda decision in the subsequent reporting period?

If an entity considers that the explanatory material in an agenda decision confirms its application of IFRS Standards is inconsistent with how it has previously accounted for certain transactions, then all reasonable efforts should be made to quantify the impact of the agenda decision as soon as possible. However, the IASB also recognises that entities should be permitted 'sufficient time' to implement any changes that result from an agenda decision.

Accounting for an agenda decision when published

Any change in accounting treatment, resulting from an agenda decision published in the same reporting period, will generally be accounted for as a voluntary change in accounting policy in accordance with NZ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The change in accounting policy must be applied retrospectively (as if the accounting policy had always been in place), meaning adjustments may be required to the prior year comparative information.

Accounting for an agenda decision in the subsequent reporting period

We understand that some entities will require more time to fully assess the impact of the April 2021 Agenda Decision and that this assessment may not be completed until after their 2021 financial statements are authorised for issue. This may be particularly the case for entities with 30 June balance dates or when 31 March financial statements are yet to be completed.

For entities that have multiple SaaS arrangements with different terms and conditions, there may not be sufficient time before the 30 June financial statements are authorised to fully consider the impact of the April 2021 Agenda Decision. In particular, this may be the case when significant configuration and customisation costs associated with SaaS arrangements have been capitalised in previous periods.

More time may be needed to ensure any change in accounting policy, resulting from an agenda decision, results in information that faithfully represents the effects of the transactions and provides useful, complete, and reliable information.

Change in accounting policy or error?

When a reporting entity concludes that it does not have sufficient time to fully consider the impact of an agenda decision at the reporting date, the accounting impact of the agenda decision will be reflected in the financial statements of the subsequent reporting period. In these circumstances, the entity will need to consider whether the impact on prior periods should be accounted for as a change in accounting policy or an error in accordance with NZ IAS 8.

In both circumstances, the accounting outcomes will be similar (both require retrospective application), but we can understand the reluctance to label an adjustment to previously reported numbers as an "error".

> An adjustment to prior period amounts reported in financial statements is defined by NZ IAS 8 as a *prior period error* when it arises from a failure to use, or misuse, of reliable information that:
>
> (a) was available when financial statements for those periods were authorised for issue; and
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> (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

The explanatory material in an agenda decision represents reliable information that was available when the financial statements for that period were authorised for issue. It is therefore expected that all reasonable efforts will be made to reflect the impact of agenda decisions in the same period in which an agenda decision is published.

However, the IASB also recognises that entities should be permitted 'sufficient time' to implement changes that result from an agenda decision. The concept of 'sufficient time' is similar to the concept of 'reasonable expectation' in NZ IAS 8, whereby a prior period adjustment is only considered an error if it is "reasonable" to expect an entity to have taken this information into account at the reporting date.

When 'sufficient time' is not available to fully consider an agenda decision before the reporting date, we expect that reflecting the impact of agenda decision in the subsequent reporting period will be accounted for as a change in accounting policy – subject to the application of professional judgement when considering the principles and requirements in NZ IAS 8.

Note disclosure

Where it is likely that adjustments in relation to the April 2021 Agenda Decision may be material, but the entity cannot fully assess the impact when the financial statements are authorised for issue, it is expected that this fact should be prominently disclosed.

This disclosure would explain that the entity is still considering the impact of the agenda decision, the plan for considering the agenda decision, the timing of when any changes are expected to be made, and any information known at the reporting date about the expected financial impact from any expected change in accounting policy as a result of the agenda decision.

Does the April 2021 Agenda Decision apply to other types of software and cloud-based computing arrangements?

Other types of software and cloud-based computing arrangements

Companies and other reporting entities currently have a wide range of options available to obtain their software requirements – including purchasing the software from an external provider, internally developing the software themselves, or acquiring access rights to software through cloud-based solutions.

A SaaS arrangement (as considered by the April 2021 Agenda Decision) is just one type of cloud-based software solution currently available. Other common examples include:

- IaaS – Infrastructure as a Service: A cloud-based service where a third party offers essential data storage, and networking resources on demand over the internet, on a pay-as-you-go basis.
- PaaS – Platform as a Service: A cloud-based service where a third party delivers hardware and software tools over the internet, on a pay-as-you-go basis.
- DaaS – Desktop as a Service: A cloud-based service where the provider hosts and manages an end-to-end desktop service with options that accommodate virtual and traditional desktops and a variety of service and management models.

Applicability of April 2021 Agenda Decision

Any explanatory material provided in an agenda decision only seeks to explain how the applicable principles and requirements in IFRS Standards apply to the transaction or fact pattern described by the agenda decision. An agenda decision, including any explanatory material, is not intended to explain how to account for other similar transactions.

Although the April 2019 Agenda Decision is not intended to help explain the accounting of other transactions (other than the fact pattern described), it serves as a useful reminder to carefully apply the existing principles and requirements in IFRS Standards when accounting for other types of software transactions and cloud-based service arrangements.

Determining the appropriate accounting treatment of any development, implementation, and ongoing service costs related to software and other cloud-based software solutions should be based on the existing principle and requirements in NZ IAS 38 *Intangible Assets* and other applicable IFRS Standards.

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