

Configuration or customisation costs in a cloud computing arrangement

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Points of reference for preparers of financial reports

Introduction

IFRIC (the International Financial Reporting Interpretations Committee, a committee of the International Accounting Standards Board) received a request addressing how a customer should account for costs of configuring or customising a supplier's application in a Cloud Computing or Software as a Service (SaaS) arrangement. It was identified that significant diversity in practice had developed and it was determined appropriate for an Agenda Decision to be drafted and released. It was determined by IFRIC that sufficient guidance exists within the relevant accounting standards and that no amendments to accounting standards were required. The rationale for arriving at this conclusion – which forms part of the interpretation of IFRS – forms the Agenda Decision.

What is cloud computing?

Cloud computing is a confusing term that can be interpreted in a variety of ways, with differing consequences. Generally, computing arrangements can be broken into three broad categories.

In the first two categories, a license to use the software as the purchaser sees fit is typically granted. This includes an ability to choose where and how the software operates, and whether it operates at all. In the first category, the software operates in environments owned and operated by the entity acquiring the license – for instance, a local operating system on a desktop computer. In the second category, the purchaser has chosen (but not been forced) to operate the software in a third party's environment. This option may be selected to operate an ERP or other business critical platform on the basis of guaranteed uptime, distributed backups, and guarantees of otherwise unavailable levels of data security.

In the third class – widely described as 'SaaS' – the purchaser has been granted a right to access software and use it for their purposes. No right to transfer the software to another platform or to control the method of operation of the software is granted.

This IFRIC Agenda Decision relates to this third class.

Software Agreement Classes

Licensed software on premise
Licensed software off premise
Software as a Service

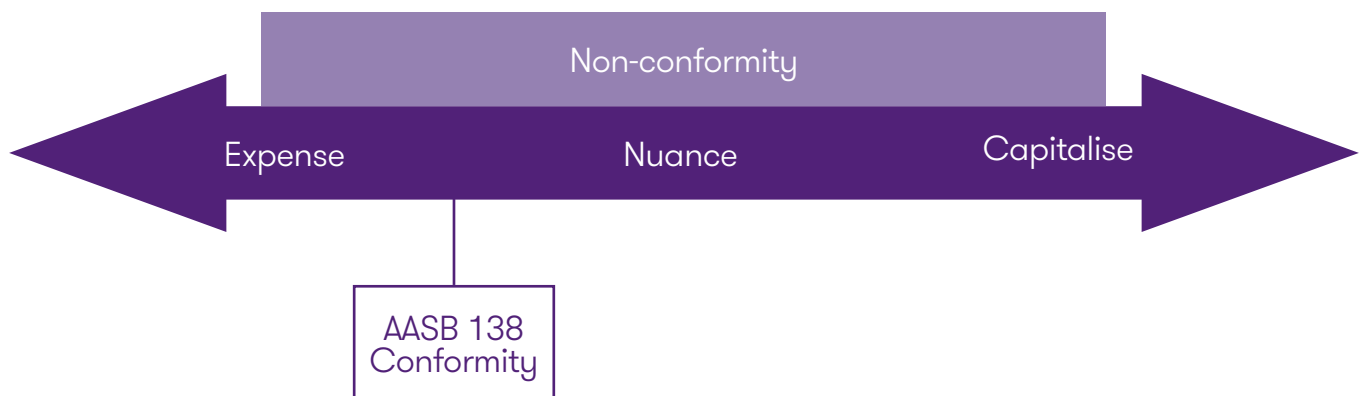
Owned	Off premise software	On premise software	Owned software is able to be controlled by the purchaser – including selection of updates and hardware.
Right of access	SaaS	Unusual in practice	Software with a right of access is unable to be controlled by the purchaser – the provider chooses hardware, application of updates, etc., within limits of contract.
	Hosted	Not hosted	A hosted environment is one where the purchaser does not control the hardware upon which the software operates.

What was the diversity in practice?

In its consultation on the issue, IFRIC identified that various approaches to customisation and configuration costs for cloud computing arrangements were utilised by companies depending on internal policy. These policies varied from expensing all costs in full to capitalisation of all costs in full, with most entities taking a more nuanced approach in their capitalisation policy and differentiating between expenditure with different underlying fact patterns

In its agenda decision, IFRIC determined that a nuanced approach was appropriate depending on the facts and circumstances of the projects undertaken and the rights and obligations of the entity as it relates to the individual elements of the projects.

Many entities will find that their historic policies, though nuanced, will not conform to the principles as described by IFRIC.



Example 1a: Strict expense policy

An entity has a strict policy – any expenditure related to a potential intangible asset is expensed without application of AASB 138 to the transaction. Such transactions are non-compliant with AASB 138 on the basis that a transaction that was an intangible asset was expensed.

The accounting standards do not permit accounting policies that are overly conservative.

Example 1b: Strict capitalisation policy

An entity has a strict policy – any expenditure related to a potential intangible asset is capitalised without application of AASB 138 to the transaction. Such transactions are non-compliant with AASB 138 on the basis that a transaction that was not an intangible asset was capitalised.

The accounting standards do not permit the policies that are overly aggressive

Example 1c: Capitalisation per the conceptual framework

An entity has established a policy that requires the recognition of an asset per the requirements of AASB 138. Where a AASB 138 asset does not exist, it applies the Conceptual Framework for Financial Reporting (“CF”) and recognises certain elements of expenditure as an “Other Asset” amortised over the life of the SaaS agreement.

AASB 138 requires that such expenditure that does not qualify for capitalisation be expensed. The CF cannot override an Australian Accounting Standard

What does the Agenda Decision require?

The Agenda Decision requires that management capitalise those elements of expenditure that meet the definition of an “Intangible Asset” as defined by AASB 138 Intangible Assets and recognise any additional amounts as an expense as the entity benefits from the expenditure – either by applying AASB 138 or applying another accounting standard.

The Agenda Decision then clarified:

- The nature of expenditure that met the definition of an Intangible Asset;
- Methods of differentiating between Intangible Assets and expenses; and
- The pattern in which the entity benefits from expenditure that does not qualify as an Intangible Asset.

Configuration involves using existing code.

Customisation modifies or adds new code.

The entity must, through the exercise of its rights, be able to prevent others from accessing the benefits of the asset.

An intangible asset requires a legal right being assigned (a license) or the right to transfer ownership (copyright) that the entity controls.

Intangible asset vs expense

IFRIC identified that disparity in practice was caused in part by confusion over the definition of an Intangible Asset and whether costs incurred met the criteria to be recognised as an Intangible Asset. To assist with this differentiation, IFRIC identified two general ‘buckets’ of implementation cost incurred in a cloud computing arrangement:

- Configuration costs; and
- Customisation costs.

Configuration costs were defined as “involving 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 was defined as “involving modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.” (NB: emphasis added).

- An Intangible Asset is recognizable when it has the following characteristics (AASB 138.12 to .13):
- The asset is separable and transferable from the entity, or arises from contractual or other legal rights;
- The asset is a resource controlled by the entity; and
- The entity has the power to obtain economic benefits flowing from the resource and restrict the access of others to those benefits.

From the above, IFRIC has communicated that it is typical that the software underlying a cloud computing arrangement is not transferred to a customer, and the setting of flags (i.e. configuration) in third party software does not provide a separable and transferable, or contractual, right to an asset as no asset that is separate from the software has been created

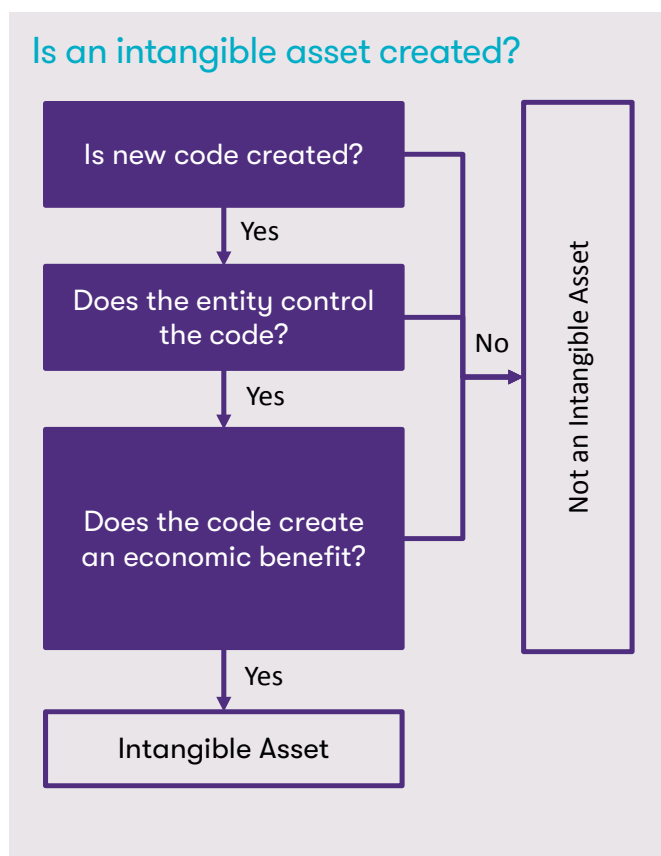
IFRIC also addressed the potential for customisation costs to meet the definition of an Intangible Asset. IFRIC identified that in certain situations, customisation costs MAY be required to be capitalized. This will be applicable where the entity has engaged resources (internal or external) to create software to which the entity retains intellectual property rights. Grant Thornton notes that this is generally not the case where code is created for operation ‘in the cloud’ as such additional enhanced functionality generally remains the property of the third part cloud computing provider.

When is an Intangible Asset most likely to be created?

An Intangible Asset is most likely to be created where the entity is investing in specific technology to bridge a gap in capability - and rights to that investment are retained by the entity. Generally, the rights related to technology developed by a supplier where that supplier also provides the platform will not vest with the customer. Specific negotiation is generally required to retain the rights to the developed software, often at increased cost. The transfer of rights may also be incomplete as the software may also be developed using intellectual property which is retained by the counterparty.

Notwithstanding this, there are certain hypothetical examples where an intangible asset may be created:

- Development of a legacy platform / SaaS integration; or
- Modification of systems in order to utilise SaaS output.



Where an Intangible Asset does not exist: The pattern of benefit

Certain entities had identified that an Intangible Asset did not exist for all or part of expenditure related to configuration and/or customisation of a cloud computing arrangement. Disparity in practice existed as to the recognition of expense in relation to this expenditure; certain entities recognising the expenditure as an expense when incurred, while others were recognising the expenditure as an 'other asset' and recognised the expenditure as an expense over the life of the cloud computing arrangement.

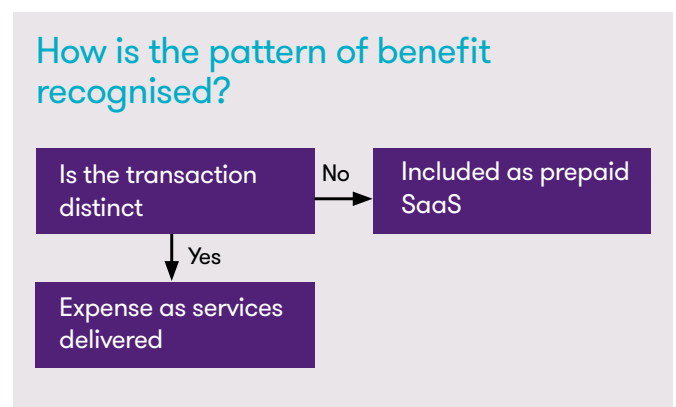
IFRIC identified that the deferring of expenditure over the life of the cloud computing arrangement is inappropriate as AASB 138.69 requires that expenditure on services that is not capitalised be recognised as an expense when it receives the services. The judgements then applied by the entity relate to the timing and value of these non-qualifying services.

In arriving at this conclusion, IFRIC has considered the nature of SaaS arrangements and concluded that they are, service arrangements as suggested by their name – Software as a Service. In a service arrangement, the benefit of the arrangement is generally received over the period of use of the service. As the period of use is generally the period of the contract, in this document this is used as a proxy for the period of benefit.

IFRIC further identified that certain contracts will contain services that are separate to that of the underlying SaaS arrangement and able to be accounted for separately to that arrangement – services that are 'distinct' – and services that are unable to be separated from the arrangement – services that are 'not distinct'.

Generally, services that 'not distinct' are unable to be separated from the SaaS arrangement and recognised as an expense on the same pattern as the SaaS arrangement. Services that are 'distinct' are recognised as the benefit is received – generally as the services are delivered.

Services that are provided by a third party are often distinct from the SaaS arrangement as per the definition of 'distinct' in AASB 15 Revenue from Contracts with Customers, however judgement should be applied.



What is meant by distinct?

As identified on the previous page, IFRIC has referenced concepts first introduced in AASB 15 Revenue from Contracts with Customers in providing guidance on the timing of expenditure for these services. Where the services are considered 'distinct' from other elements of the contract, they are addressed as a separate element and are expensed as and when the services are provided – typically in a relatively short time period. Where the services are not considered distinct from other elements of the contract – i.e. other Performance Obligations as defined by AASB 15 – they are required to be bundled with those other elements and recognised as an expense in the same pattern as those other elements.

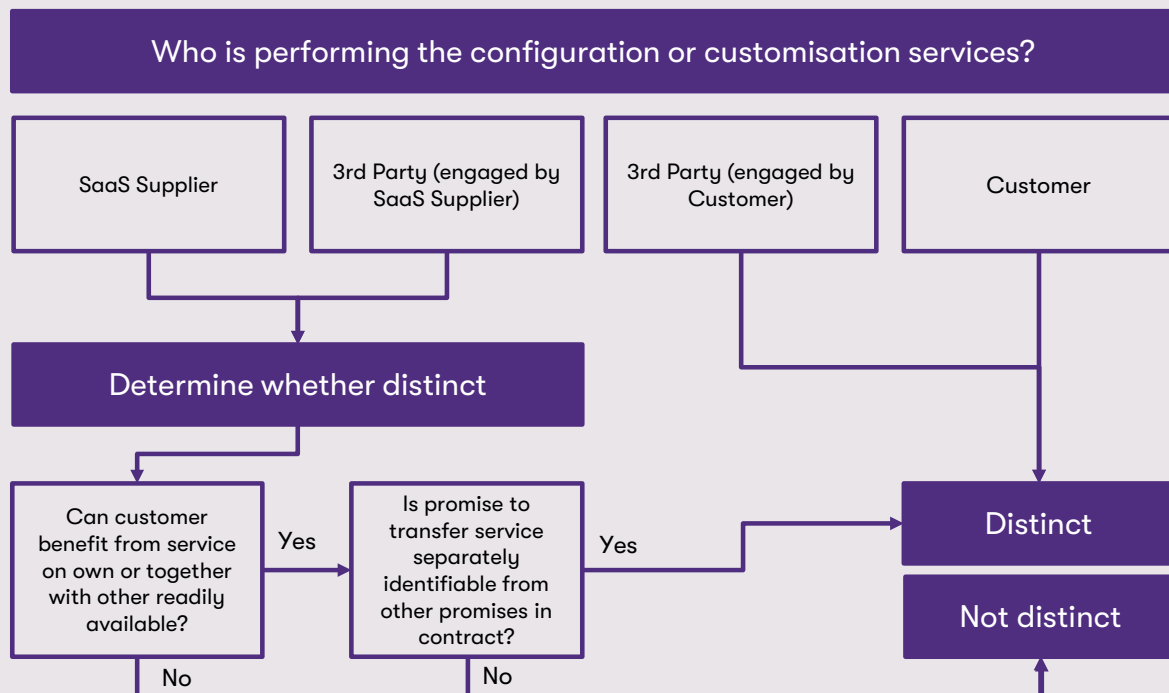
Paragraph 27 of AASB 15 defines a good or service as distinct if both of the following criteria are met:

- a the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and
- b the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract).

Such determinations are widely covered in AASB 15 guidance and as a result we will not expand in detail in this document, other than to note that the application of this guidance requires the customer to consider a transaction from the supplier's perspective in addition to their own.

As noted above, services offered by a third party may or may not be distinct. If engagement by the customer, they will not be distinct as it demonstrates that the SaaS platform is able to be benefited from without additional services by that supplier. If engaged by the SaaS supplier, they can be considered.

Is a Service Arrangement distinct



Transactions with elements of both Intangible Asset and Expense

It will be common to encounter situations where a contract (or contracts) with a supplier will include elements that both do and do not meet the definition of an Intangible Asset – and also situations where a transaction with a supplier contains elements that both are and are not distinct from the underlying cloud computing arrangement.

IFRIC did not provide additional guidance on the identification of value, however other guidance exists that is applicable in this instance – specifically, Grant Thornton would recommend a relative-value approach be utilised for the elements identified.

Error or change of Policy?

IFRIC has identified that disparity in practice exists and has issued the Agenda Decision on the basis of clarifying which policies are acceptable. In the opinion of Grant Thornton, it is appropriate in this instance to consider the correction of any related recognition and measurement arising from the application of the Agenda Decision as a “Change in Policy” rather than a “Restatement due to Error”.

While the form of restatement of prior periods is similar, it is appropriate in this instance to refer to a change in policy as a result of the IFRIC Agenda Decision rather than a restatement due to prior period error.

In the instance of a change in policy, the appropriate disclosures are described in AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors paragraph 29 and include the elements below:

- The nature and change in accounting policy;
- The reasons why applying the new accounting policy provides reliable and more relevant information;
- For the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
 - For each financial statement line item affected; and
 - If AASB 133 applies to the entity, for basic and diluted earnings per share;
 - The amount of the adjustment relating to periods before those presented, to the extent practicable; and
- If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

When should the policy be implemented?

For certain entities, the adoption of the new policy will result in minimal impact as a result of known limitations in the volume of contracts that are within the scope of the Agenda Decision. For other entities, the impact will be broader and may require significant projects to be undertaken to obtain, collate, and make judgements on the underlying information. It is therefore generally accepted that the Agenda Decision may require multiple years’ effort to both determine the impact of the Agenda Decision and adjust the financial statements of an entity; it is also appropriate for entities to expedite the adoption of a revised policy in response to the Agenda Decision.

In its 10 June 2021 media release 21-129MR, ASIC highlighted that “... there should be sufficient time to identify past amounts capitalised that should be expensed before 30 June 2021 financial reports are completed.” In its wording, and in other communications, ASIC has clearly communicated that adoption should be expedited, with a communicated expectation that entities should seek a 30 June 2021 adoption date – with adoption required by the next reporting date after 30 June 2021.

A general expectation has been communicated that all entities will have adopted the new policy by 31 December 2021. We do note, however, that accuracy is paramount. While an entity should seek to expedite adoption, corporate governance will require that appropriate controls are implemented to ensure accuracy in adoption which may require a more deliberate approach to ensure material accuracy.

The Grant Thornton view is that the adoption of Accounting Policy is governed by AASB 108 which does not allow for an ‘incomplete’ adoption of a policy. Any adoption should be completed in a single step and not involve restatement over multiple periods.

Additional considerations

Disclosure prior to adoption of new policy

AASB 108 does not address circumstances where IFRIC has released an agenda decision that impacts an entity's choice of accounting policies and the entity is in the process of determining the impact of that change in policy. In such a situation, where an entity suspects that the mandatory change in policy may be material to its financial statements, it is our opinion that it is appropriate for the entity to disclose sufficient information for users to understand the potential impact the change in policy may have on the financial statements. These disclosures are recommended to take a form similar to those described in AASB 108.30 and include:

- The fact that the Agenda Decision impacts the entity;
- That the Agenda Decision has not been implemented as a change in policy;
- Known or reasonably estimable information relevant to assessing the possible impact that application of the change in policy will have on the entity's financial statements in the period of initial application;

We also recommend that paragraph 31 be applied by analogy, encouraging disclosure of the following (or, if in brackets, analogising to):

- a the title of the new Australian Accounting Standard (IFRIC Agenda Decision);
- b the nature of the impending change or changes in accounting policy;
- c not applicable
- d the date as at which it plans to apply the Australian Accounting Standard (IFRIC Agenda Decision) initially; and
- e either:
 - i a discussion of the impact that initial application of the Australian Accounting Standard (IFRIC Agenda Decision) is expected to have on the entity's financial statements; or
 - ii if that impact is not known or reasonably estimable, a statement to that effect.

AASB 108 should be applied by analogy – including disclosure of potential impacts of the new policy.

Disclosure of adoption of new policy

AASB 108 defines the required disclosures for entities that have implemented a new accounting policy in a period. Paragraph 29 of AASB 108 requires the following to be disclosed (paragraph 29):

- a the nature of the change in accounting policy;
- b the reasons why applying the new accounting policy provides reliable and more relevant information;
- c for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
 - for each financial statement line item affected; and
 - if AASB 133 applies to the entity, for basic and diluted earnings per share;
- d the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- e if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Of particular note, we draw attention to item c (left), which requires that the impact on the current period and each prior period presented be disclosed. This will require that the period of change in policy be

AASB 108 requires that, in a change of policy, information for the current period be presented as complying with both policies (in the notes).

What is meant by “impracticable”?

In certain situations, it is impracticable for entities to obtain information in sufficient detail to determine the impact of historic transactions when applying a new policy. This situation may arise, for instance, where records are no longer retained by the entity.

In our experience, it is not unusual for information in records to be difficult to obtain – for instance, due to archiving. In such a situation, it is not ‘impracticable’ but ‘inconvenient’. An example of data that is “impracticable” to obtain is given by AASB 108.50 as: “data [that] may not have been collected in the prior period(s)...”. (emphasis added). In our opinion, data that ‘may not have been collected’ is data that does not exist or was not retained – for instance, the number of simultaneous users where the fields were not added to a database. Data retained in invoice or other form that is not structured organized is data that is collected but not collated – such data is NOT impracticable to be obtained due to the ability to obtain the information with sufficient effort.

The Oxford Dictionary defines “Impracticable” as:

“impossible to carry out, not feasible”

Grant Thornton notes that “difficult” or “expensive” is not within the definition.

Example 2a: Practicable

An entity has entered into contracts over a period of time that may give rise to an Intangible Asset. The entity has sufficiently detailed records of transactions entered into with third-party providers, however these are stored in hard copy in archive.

Accessing the information will be time consuming and incur a significant cost.

Accessing the information is practicable.

Example 2b: Impracticable

An entity has undertaken significant investment in SaaS platforms, creating internally developed integrations with these platforms. The cost incurred was not monitored and supporting documentation does not exist.

It is impracticable for the entity to identify the value of Intangible Assets created as

Example 2c: Impracticable

An entity has undertaken significant investment in SaaS platforms, creating internally developed integrations with these platforms. The cost incurred was monitored via a detailed timekeeping system, however records are not retained past seven years in line with corporate governance requirements.

It is impracticable for the entity to calculate the value of Intangible Assets created as it relates to costs incurred more than 7 years prior to transition to the new policy.

Example 2d: Impracticable

An entity does not retain documentation for the legally required seven year period but for three years only. It is impracticable for the entity to calculate the value of Intangible Assets created as it relates to costs incurred more than three years prior to transition to the new policy. The auditor should consult with NAQ as a breach of the Corporations Act 2001 has occurred

Example 2e: Impracticable

An entity stored its hard copy source documents in a container which was lost in a factory fire.

It is impracticable for the entity to calculate the value of Intangible Assets.

Practical application – Navigating the process

Developing a materially correct balance sheet when addressing historic transactions can be difficult as it requires understanding:

- The period for which information is available (generally assumed to be seven years in Australia);
- The projects implemented, or being implemented, at a particular point in time;
- The relative impact of historic transactions on the balance sheet and income statement for all periods presented in restated financial statements
- Completing the above without the influence of hindsight.
- The related data points associated, including:
 - Third party contracts;
 - Third party invoices;
 - Internally incurred costs (payroll, etc);
 - Whether each element of expenditure qualified for capitalisation at the point in time;
 - Whether a non-capitalisable item is distinct or not from the underlying cloud computing arrangement, and
 - The value capitalised (or expensed) that will require reassessment.

Capturing the required data

Where activity has been identified for assessment, it may be appropriate to involve expertise outside of the accounting function – for example, operations or information technology – in order to ensure data captured is correct and accurate. Additional complexity will arise in ensuring that information collected is auditable. As the totality of expenditure increases towards being material, the quality of information required to demonstrate the allocation of transactions or portions of transactions to either expenditure or intangible assets increases.

Ideally, each project would be considered as a series of sub-projects. Information that may be required to be captured includes:

- Project Name
- Project Sponsor
- Project Goal
- Impacted Systems
- Developer (e.g. external provider, internal coders)
- Assessment of whether any potential intangible assets exist
- Assessment of whether any potential non-distinct expenditure exist
- References to supporting information (contracts, invoices, MSAs, etc)
- Preparer of collated information
- Reviewer of collated information (subject matter expert)
- Reviewer of collated information (appropriately qualified finance professional)
- Invoices associated
- Total expenditure

By logging this information, management can demonstrate

a clear understanding of the value received in exchange for the expenditure on the project. Management can then focus its attention on projects where additional judgement may be required to be applied. Information captured in this process may include:

- Description of sub-projects
- Systems impacted
- Direct costs incurred on the sub-project
- Discussion of the sub-project and the application of AASB 138
- Expected useful life of the project (if capitalised)
- Contractual life of the cloud computing arrangement (if not distinct)

We recommend that entities undertaking large numbers of cloud computing projects develop a robust, AASB 138 accounting policy and related decision templates to ensure compliance with Australian Accounting Standards.

Navigating consequential accounting considerations

While it can reasonably be expected that for most entities, the value of qualifying projects that are not yet available for use may be immaterial, in certain situations – e.g. large scale implementations and integrations – material intangible assets may be recorded at a reporting date that are not yet in production. AASB 136 Impairment of Assets requires that intangible assets that are not yet available for use be tested for impairment at least annually – including in the year of their acquisition.

Management should therefore ensure that any material balances are tested for impairment as required by AASB 136.10.

Calculating the impact

Calculating the impact of a change in accounting policy involves a full restatement of historic financial information presented in the financial statements – including restating historic results that are presented as adjustments to retained earnings.

This requires the entity to understand the financial statement impact for each period impacted – interpretable as every period in which transactions impacted by the entity have occurred.

Understanding the nature of transactions and the expected maximum useful life of any intangible assets created will allow an entity to create a maximum period of look-back. This period of look-back will also be limited by data retention policies in place.

Materiality

Certain entities, by reference to their internal metrics, may determine that the impact on the financial statements of the change in policy to be immaterial historically. While this may be true for internal reporting purposes – especially for entities whose internal performance measures are not impacted by the change in policy – it will not necessarily be true for all stakeholders, particularly those that are external to the entity.

In the Australian marketplace, with the requirement that external parties be provided access to general purpose financial statements for all entities reporting per the requirements of the *Corporations Act 2001*, there is a general expectation that materiality should be measured based on the lens through which those external parties would view the financial statements.

It may therefore not be appropriate to consider transactions as ‘material’ or ‘immaterial’ by reference to purely internal metrics, but instead consider the impact on other metrics such as total assets or net profit after tax.

Paragraph 7 of AASB 101 *Presentation of Financial Statements* provides a comprehensive definition of ‘Material’.

This definition should also be considered in conjunction with more detailed definitions of ‘material’ utilised by auditors. A key element of clarity provided by the relevant auditing standard – ASA 320 *Materiality in Planning and Performing an Audit* – is that the individual needs of specific users should not be considered in assessing materiality, but by considering users as a whole. In the Australian context, users can reasonably include regulators and users who obtain financial statements via publicly available databases such as those maintained by ASIC.

ASA 320 also clarifies that for the purpose of audit, materiality is both quantitative and qualitative – and if a quantitative error has been identified, it should be assessed against the identified quantitative materiality.

Together and individually, AASB 101 and ASA 320 do not allow consideration of materiality on a relative percentage basis. While historic practice may have assessed an item as immaterial if it comprised <10% of a balance, this is no longer appropriate.

Example 3

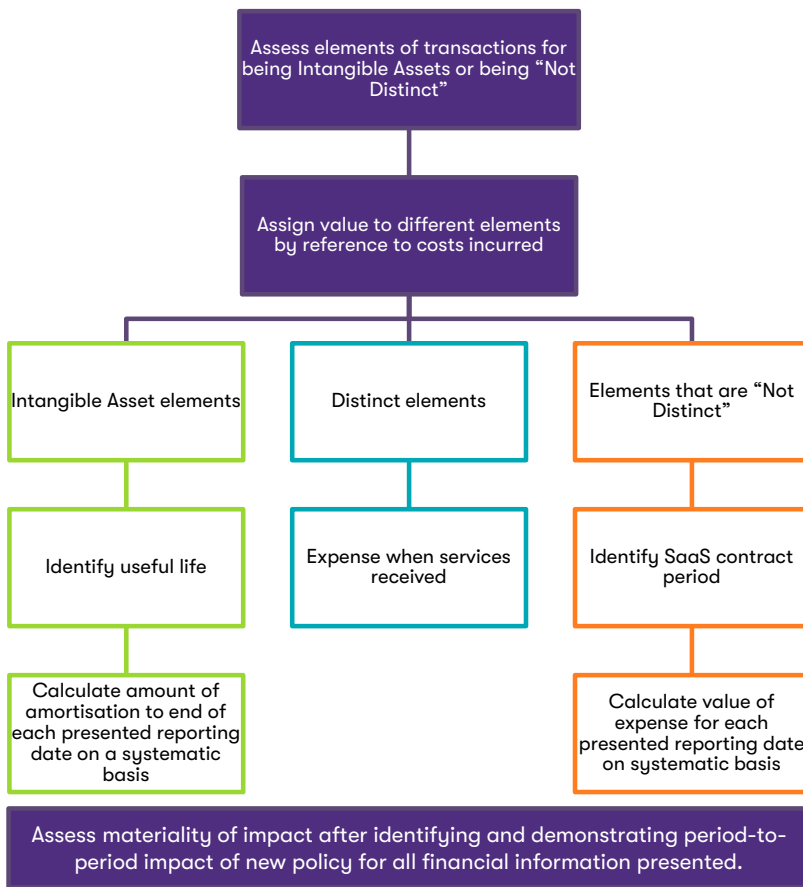
An entity has undertaken significant investment in SaaS platforms, creating internally developed integrations with SaaS platforms. All cost was incurred with third parties and expensed as incurred.

Certain projects completed 8 years prior to reporting date resulted in intangible assets as defined by AASB 138, however the relevant records were destroyed in accordance with corporate policy and in compliance with the *Corporations Act 2001*.

The entity is unable to calculate the impact of the change in policy for these historic transactions and limits its look-back period to seven years.

AASB 101.7

“Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.”



“Distinct”

An element of a transaction is distinct from (or capable of being distinct from) the underlying SaaS contract if the company can benefit from either element of the contract without the other.

If a third party delivers a service, it cannot be included as a part of the SaaS contract and should be considered a “Distinct element” in the flow chart.

“Systematic”

Generally, matching to the pattern of benefit received (e.g. relative volume or time based).

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