In depth

A look at current financial reporting issues

29 November 2021

Accounting for SaaS arrangements

At a glance

Digital transformation is one of the key agenda items for many entities. Many entities are using cloud computing technology, and Software-as-a-Service (SaaS) arrangements are a popular option.

IFRS does not provide specific guidance on how a receiving entity (the buyer) should account for SaaS arrangements. The IFRS Interpretations Committee (IFRIC) published two agenda decisions in March 2019 and March 2021 (the latter was ratified by the IASB in April 2021) that assist buyers to consider the appropriate accounting.

This In depth summarises the key principles of these two IFRIC agenda decisions and areas which an entity should consider when applying the accounting.

Please note the views discussed in this publication represent our perspectives as of the date of this publication. Our views might evolve when we continue to analyse more real life cases and make additional observations.

What are cloud computing arrangements?

Cloud computing arrangements are where a customer accesses and uses software over the internet. The most popular arrangements are SaaS.

What is a typical SaaS arrangement?

SaaS arrangements are typically where software applications are delivered over the internet on demand, usually via a subscription. The service provider hosts an application and manages the associated infrastructure.

IFRIC agenda decisions on SaaS arrangements

The IFRIC issued two agenda decisions on SaaS arrangements:

A. the March 2019 agenda decision considered whether a customer receives a software asset or a service when the customer pays a fee in exchange for a **right to receive access** to a supplier's application software on a cloud infrastructure managed and controlled by the service provider, for a specified term.

B. the April 2021 agenda decision builds on the 2019 agenda decision and considers how a customer accounts for **configuration** and / or **customisation** costs incurred in SaaS arrangements where it has been concluded that the arrangement does not constitute a software asset of the customer.

Apart from the accounting for the costs described above, entities will need to carefully analyse development and implementation costs incurred as many of these costs are beyond the scope of the IFRIC agenda decisions. For example, costs could represent a bespoke software module that the entity has developed to interact with the SaaS service. This bespoke software module might be capitalised as an intangible software asset if it is identifiable and controlled by the entity. Other examples are set out in **Appendix B** to this document.

Configuration and Customisation defined in April 2021 IFRIC 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 or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.

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A. March 2019 IFRIC agenda decision – customer's right to receive access to the supplier's software hosted on the cloud

Cost categories covered by the March 2019 IFRIC agenda decision

Fees paid in exchange for a right to receive access to the supplier's application software.

IFRIC discussion at a glance

A customer receives a software asset if **either**:

a. the contract contains a software lease, **or**

b. the customer otherwise obtains control of a software intangible asset.

a. Does the contract contain a software lease?

A contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Consider whether, throughout the period of use, the customer has both the right to:

- obtain substantially all the economic benefits from use of the identified asset, **and**
- direct the use of that identified asset.

IFRIC's observations

The **right to direct the use** of an asset could be, for example, deciding how and when to update the software, or on which hardware (or infrastructure) the software will run. Accordingly, if the customer only has the right to receive access to the supplier's application software, the contract does not contain a software lease.

b. Does the customer obtain control of a software intangible asset through the right to access the software?

IAS 38 defines an intangible asset as 'an **identifiable non-monetary asset** without physical substance' and notes that an asset is a resource controlled by an entity. An entity controls an asset if it has 'the **power to obtain the future economic benefits** flowing from the underlying resource and to **restrict the access** of others to those benefits'.

IFRIC's observations

Where a contract only gives a customer a **right to receive access** to the supplier's application software, the customer does not receive a software intangible asset. This is because the supplier holds, manages and updates the software over the period and has not given up or transferred its own rights relating to access and use of software.

Where a customer receives **rights beyond a right of access**, this could indicate that a customer obtains control of an intangible asset. Refer to **Appendix A** for some of the factors that management could consider when determining whether the definition of control is met.

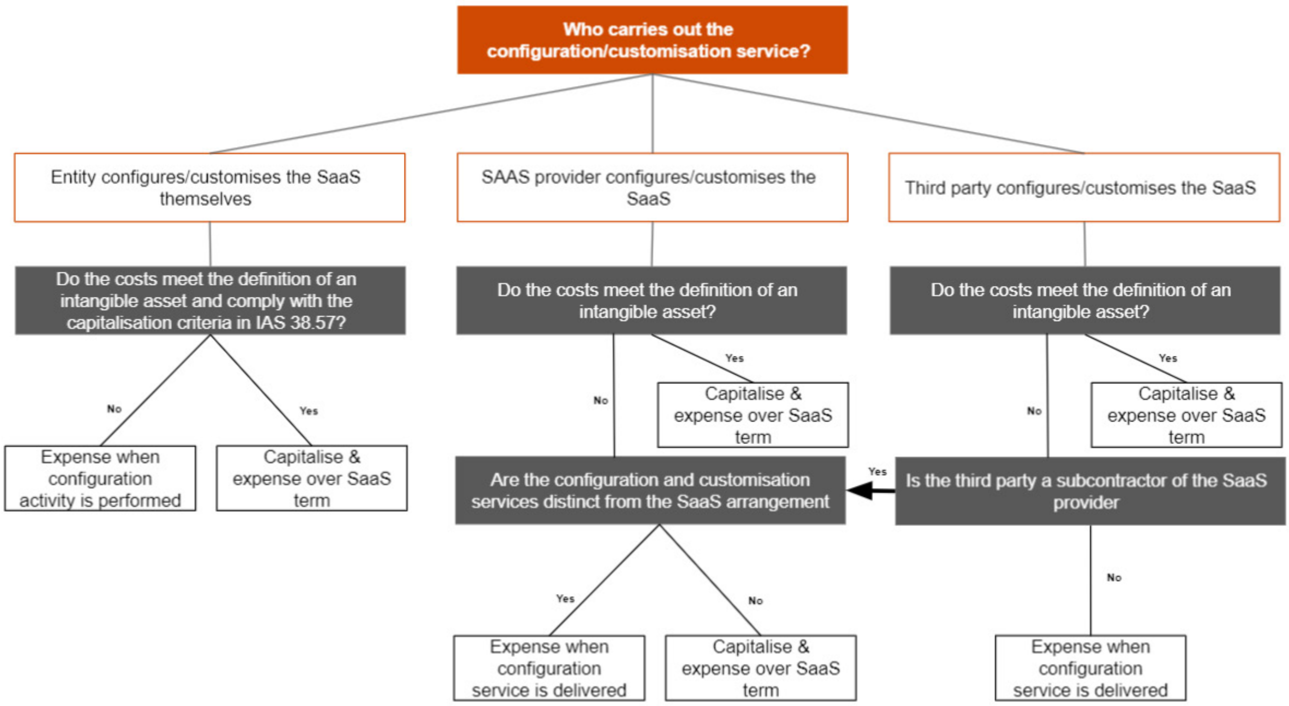
B. April 2021 IFRIC agenda decision – configuration or customisation costs in a cloud computing arrangement

Cost categories covered by this IFRIC agenda decision

This IFRIC agenda decision only relates to configuration and customisation costs in SaaS arrangements.

IFRIC discussion at a glance

The decision tree below sets out the accounting considerations in relation to customisation and configuration costs:



If the SaaS arrangement does not provide a customer with control of the configuration and / or customisation, then any related internal or external costs paid to a third party (not subcontracted by the SaaS provider) are expensed as incurred (i.e., as an operating expense, above EBITDA).

However, configuration or customisation costs paid to a SaaS provider or a third party subcontracted by the SaaS provider could either be expensed as incurred or capitalised as a prepayment and expensed over a period of time depending on whether the promises set out in the service arrangement are distinct / separable from other promises (especially the ongoing access to the SaaS provider's application software) within the SaaS arrangement.

The customisation or configuration services are likely not-distinct / not-separable from other promises if the:

a. SaaS provider provides a significant integrating service to produce a combined output with other services, or

b. service significantly modifies or customises the other service(s), or

c. services provided are highly interdependent or highly interrelated to each other.

If the conclusion is that the service is **not-distinct / not-separable**, costs paid (either to the SaaS provider, or a third party subcontracted by the SaaS provider) before the commencement of the hosting period would be eligible to be capitalised as a prepayment. Consideration should also be given to the classification of this prepayment as current or non-current.

These costs would then be released to the profit or loss as an expense over the period that the entity expects to benefit from such expenditure (expected SaaS term). The expected SaaS term might be beyond the initial SaaS contractual term.

If the conclusion is that the service is **distinct**, costs (paid to the SaaS provider, or a third party) for customisation or configuration, would be expensed as incurred.

Other considerations

Consideration of additional disclosure under IAS 1 – significant estimates and judgements

Consider whether the assessments above involve significant judgements or estimates and warrant disclosures in the financial statements as required by IAS 1 paras 122 and 125.

When is the April 2021 IFRIC agenda decision effective?

As with all IFRIC agenda decisions, the April 2021 agenda decision should be applied with immediate effect (as if it were an adjusting subsequent event for 31 March 2021 year ends) but entities would be entitled to sufficient time to make the change.

The change triggered by the April 2021 agenda decision is generally treated as a voluntary change in accounting policy and applied retrospectively. Entities should remember that a third balance sheet as at the beginning of the comparative period is required where there are material retrospective adjustments that affect the financial position at the start of the comparative period.

Entities may yet have to consider all the requirements and obtain the information necessary to reconsider any existing accounting treatment. Where it is likely that adjustments in relation to the April 2021 IFRIC agenda decision may be material but the entity cannot complete the assessment when the financial statements are authorised for issue, this fact should be prominently disclosed. This is similar to disclosures of other accounting pronouncements (IAS 8.30) except that management should also explain the reason(s) of why they cannot change it in this financial period. The entity should also discuss its plan for considering the IFRIC agenda decision and the expected implementation time.

Key takeaways

SaaS arrangements

- There has been no change to accounting requirements in relation to software development other than those addressed in the 2019 and 2021 IFRIC agenda decisions.
- The 2019 IFRIC agenda decision covers fees paid in exchange for a right to receive access to a supplier's application software.
- The 2021 IFRIC agenda decision covers configuration and / or customisation of the SaaS software and is built on the presumption that an entity does not control the SaaS software (item discussed in 2019 IFRIC agenda decision).
- Apart from the accounting for the costs described above, consider each stage of the software implementation project and the nature of each category of cost to determine whether an entity controls an asset following the guidance set out in IAS 16, IAS 38 and IFRS 16. See examples in Appendix B.
- This is a complex area and finance teams are going to have to work very closely with IT teams and potentially service providers to understand contractual rights in relation to customisation and / or configuration.

Where a change in accounting is required

- In relation to the 2021 IFRIC agenda decision:
  - it should be applied with immediate effect but entities are entitled to sufficient time to make the change
  - it is a voluntary change in accounting policy and must be applied retrospectively
  - where it is likely that adjustments may be material but the entity cannot complete the assessment when the financial statements are authorised for issue, this fact should be prominently disclosed in the financial statements.
- In relation to the 2019 IFRIC agenda decision or cost items not covered by 2019 & 2021 IFRIC agenda decisions, the change is likely to be a correction of an error.

Appendix A

Potential factors to consider in determining whether an entity has an asset arising from payments to access application software in a SaaS arrangement

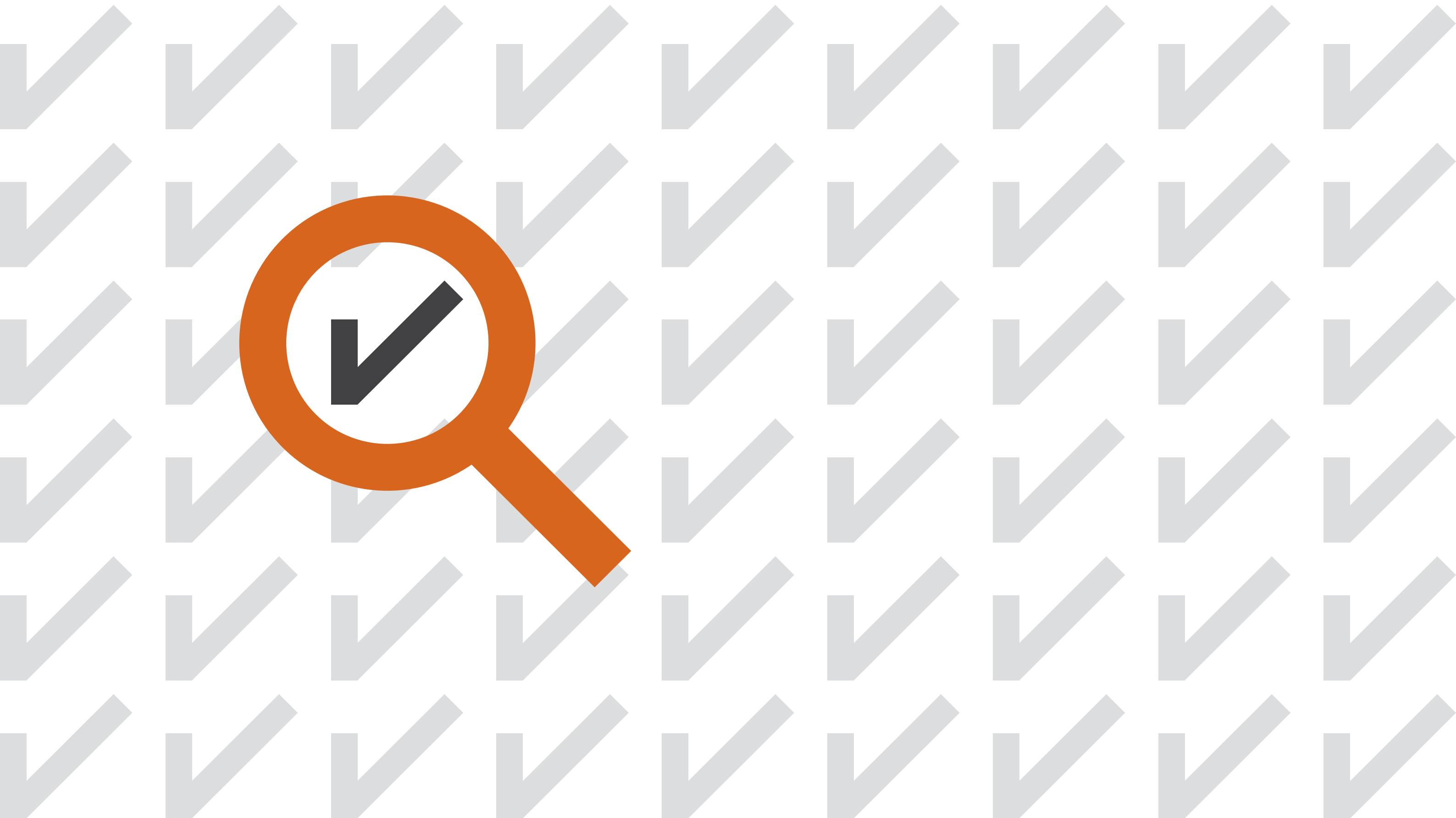
The following are examples of circumstances which could **influence** the assessment of whether the customer controls the software:

a. whether the customer has a right to possess a copy of the software, for example on termination of the contract, and also whether the customer has the ability to host the software without the supplier's infrastructure

b. whether the SaaS provider can make the modified version of the software available to other customers or whether the modified version can be used only by that specific customer (i.e., it is specified in the contract)

c. whether the software continues to be reconfigured / updated by the SaaS provider over the period of the contract, or whether the customer manages when the modified software is updated

d. whether the software is hosted purely on the SaaS provider's cloud infrastructure, or whether the customer has any control over the infrastructure on which the software is hosted



Appendix B

Software development and implementation costs

The table below illustrates which costs are typically capitalised or expensed for both on-premise solutions and SaaS software solutions. Determining which activities in the implementation process are eligible for capitalisation requires judgement and an analysis of the nature of the costs incurred.

Stages of implementation	Typically capitalised or expensed
Research phase (as defined by IAS 38)	
Research / preliminary project stage including planning e.g., internal / external costs incurred in undertaking feasibility studies, defining hardware and software specifications, evaluating alternative products and suppliers and selecting preferences prior to the selection of a supplier / provider	Expense
Development phase (as defined by IAS 38)	
Fees paid in exchange for a right to receive access to a supplier's application software (e.g., licence fee)	Consider March 2019 IFRIC agenda decision. If not an asset controlled by the entity and not a lease, expense over the life of the SaaS contract
Hardware costs	Consider if this is a lease (IFRS 16), a service, or an asset controlled by the entity (IAS 16)
Internal / external costs incurred (including workshops) to design system and process documentation – custom tailored documentation setting out definite workflows, processes and standards etc.	Capitalise if design documentation is identifiable and controlled by the entity
Modify existing system to be compatible with SaaS	Capitalise if new functionality is created. If not, expense similar to maintenance costs but consider April 2021 IFRIC agenda decision if SaaS provider performs the work
Bridging modules / interphases to existing systems	Capitalise if identifiable and controlled by the entity Further consider April 2021 IFRIC agenda decision if SaaS provider controls the code
Bespoke software modules designed to interact with SaaS software	Capitalise if identifiable and controlled by the entity
Development of bespoke reporting module	Capitalise if identifiable and controlled by the entity Further consider April 2021 IFRIC agenda decision if SaaS provider controls code

Stages of implementation	Typically capitalised or expensed
Technical configuration and customisation of SaaS software	On-premise software – capitalise SaaS arrangements: • configuration of existing SaaS functionality – expense all costs but consider April 2021 IFRIC agenda decision if SaaS provider or its subcontractor performs the work • insignificant modifications to SaaS source code – expense all costs but consider April 2021 IFRIC agenda decision if SaaS provider or its subcontractor performs the work • significant modification to SaaS source code – consider contractual rights and if identifiable and controlled by the entity, capitalise as an intangible asset, otherwise expense internal costs and consider whether costs paid to SaaS provider or to a third party subcontracted by SaaS provider should be expensed as incurred or capitalised as a prepayment and expensed over the expected SaaS term (April 2021 IFRIC agenda decision)
Costs to obtain or develop data conversion software	Capitalise if identifiable and controlled by the entity
Data conversion activities: • purging or cleansing existing data • creating or inputting new data required by the new cloud computing system • conversion of old data to new system • reconciling or balancing the new data with the data extracted from the old system	Expense
Costs to test software including cloud based computing	Depends on the nature of testing (i.e., testing of bespoke software may be capitalised, however, testing of base SaaS software should be expensed unless the software is capitalised as an intangible asset by entity (March 2019 IFRIC agenda decision)
Post-development phase	
Fees paid in exchange for a right to receive access to a supplier's application software (e.g., licence fee)	Consider March 2019 IFRIC agenda decision. If not an asset controlled by the entity and not a lease, expense over the life of the SaaS contract
SaaS hosting fees	Expense
Provision of training	Expense
Post-implementation maintenance	Expense (for significant upgrades, consider the above guidance)

Need more information?

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