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Accounting for Configuration and Customization of a Supplier's Software

Background

The International Financial Reporting Interpretations IFRIC (IFRIC) received a request about how a customer accounts for costs of configuring or customizing a supplier's application software in a Software as a Service (SaaS) arrangement. The details are shown in the Agenda Decision (AD) that follows this guidance paper.

In analysing the request, the IFRIC considered:

- a. whether, applying IAS 38, the customer recognises an intangible asset in relation to configuration or customization of the application software; and
- b. if an intangible asset is not recognised, how the customer accounts for the configuration or customization costs.

IFRIC applied the criteria in IFRS 15 with regard to distinct and non-distinct performance obligations in addressing this specific issue. It should be noted that this was not intended to establish these criteria as being relevant to all costs or expenses, but only to this specific fact pattern in the AD.

IAWG believes it would be useful to highlight the principles applied by IFRIC in addressing these questions and provide insights into how these principles may be met by an airline applying the agenda decision.

IFRIC had previously received a request regarding whether SaaS arrangements were a lease or a service contract and concluded that they were a service contract. Therefore, the customer (airline) would not have an intangible asset recorded for the software that it then contracts to have configured or customized as it does not control the software.

Analysis

Does an airline recognise an intangible asset in relation to configuration or customization of the application software in a SaaS arrangement?

IAS 38 notes that an asset is a resource controlled by an entity and IAS 38.13 specifies that 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.

In the SaaS arrangement described in the request the configuration or customization activities do not create a resource controlled by the customer.

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.

IAWG Observations

The issue of control over the configuration and customization services is a matter of substance. In addressing the issue of control over these services an airline should assess configuration and customization services and whether it has the power to obtain the future economic benefits and to restrict others' access to those benefits to support the recognition of an intangible asset.

In many cases these services will not be controlled by the airline. This is especially true when the underlying software is used by multiple parties who will therefore benefit from the services or where the vendor will be able to provide these services to other customers. There are also many cases where the configuration and customization services could only benefit the airline and then it may be appropriate to recognize an intangible asset.

If an intangible asset is not recognised, how does the customer account for the configuration or customization costs?

If the customer does not recognise an intangible asset in relation to configuration or customization of the application software, it applies IAS 38.68–69A to account for those costs. The customer recognises the costs as an expense when it receives the configuration or customization services in accordance with IAS 38.69. IAS 38.69A clarifies that services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service.

IFRIC observed that IFRS 15 includes requirements that suppliers apply in identifying the promised goods or services in a contract with a customer. They believe that those requirements in IFRS 15 deal with issues similar and related to those faced by the customer in determining when the supplier performs the configuration or customization services in accordance with the contract to deliver those services.

If the contract to deliver the configuration or customization services to the customer is with the supplier of the application software (including cases in which the supplier subcontracts services to a third party), the customer applies paragraphs IAS 38.68-69A and determines when the supplier of the application software performs those services in accordance with the contract to deliver them as follows:

- if the **services are distinct** the customer recognises the costs as an expense when the supplier configures or customizes the application software.
- if the **services are not distinct** then the customer recognises the costs as an expense when the supplier provides access to the application software over the contract term.

This criteria for determining whether a service is distinct or non-distinct is covered in IFRS 15.27:

A good or service that is promised to a customer is 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 good or service is distinct within the context of the contract).

IFRS 15.29 provides examples of factors that indicate that an entity's promise to transfer a service to a customer is separately identifiable in accordance with paragraph 27(b):

- (a) the entity does not provide a significant service of integrating the service with other goods or services promised in the contract.
- (b) the service does not significantly modify or customize another good or service promised in the contract.
- (c) the service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract.

IFRS 15.30 states that if a promised service is not distinct, an entity shall combine that service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In this case that would be with the software that has been configured or customized.

If the customer pays the supplier of the configuration or customization services before receiving those services, it recognises the prepayment as an asset in accordance with IAS 38.70.

IAWG Observations

In addressing the issue of whether the configuration and customization are distinct as defined in IFRS 15.27 it will be difficult to evidence that the resources required to use these services are not readily available. IFRS 15.28 defines a readily available resource as a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained. IFRS 15, BC100 specifies that any contractual restrictions on obtaining these services from a third party are to be ignored, so contractual restrictions would not be effective.

As both criteria in IFRS 15.27 must be met for the configuration and customization services to be distinct, it would be advisable to focus on IFRS 15.27(b).

As explained in the AD, configuration involves setting 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. Customization involves modifying the software code in the application or writing additional code. Customization generally changes, or creates additional, functionalities within the software.

IFRS 15.30 provides factors that evidence that the services are distinct, and we believe that two of those factors would frequently not be present because:

- 1. the configuration and customization services significantly modify or customize the software;
and
- 2. the configuration and customization services are highly dependent on, or highly interrelated with the software as they would not be operational without the software.

As a result, it is very likely that the configuration and customization services are not distinct and therefore should be accounted for in the same manner as the software, which is recognized over time as an expense. If these services are not distinct and paid for in advance, they would be recorded as a prepaid asset and expensed over the term of the arrangement. Note that if the configuration and customization services were provided by a part other than the cloud computing service provider that the configuration and customization services would be distinct.

Is this consistent with US Accounting Standards?

The Financial Accounting Standards Board (FASB) addressed this issue in 2018 and issued a revised standard that treats these costs the same as other software development costs. As a result, the accounting under IFRS and US GAAP could vary.

IAWG View:

IAWG believes that the AD is consistent with IFRS standards, but that the economic substance of the transaction would be best reflected as an intangible asset consistent with US GAAP. IAWG believes that an airline should be able to apply the AD to reflect the economic substance of these services as an intangible asset or by applying IFRS 15.

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IFRIC Agenda Decision: Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets)

The IFRIC received a request about how a customer accounts for costs of configuring or customising a supplier's application software in a Software as a Service (SaaS) arrangement. In the fact pattern described in the request:

- a. a customer enters into a SaaS arrangement with a supplier. The contract conveys to the customer the right to receive access to the supplier's application software over the contract term. That right to receive access does not provide the customer with a software asset and, therefore, the access to the software is a service that the customer receives over the contract term.
- b. the customer incurs costs of configuring or customising the supplier's application software to which the customer receives access. The request describes configuration and customisation as follows:
 - i. 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.
 - ii. customisation involves modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.
- c. the customer receives no other goods or services.

In analysing the request, the IFRIC considered:

- a. whether, applying IAS 38, the customer recognises an intangible asset in relation to configuration or customisation of the application software (Question I).
- b. if an intangible asset is not recognised, how the customer accounts for the configuration or customisation costs (Question II).

Does the customer recognise an intangible asset in relation to configuration or customisation of the application software (Question I)?

Applying paragraph 18 of IAS 38, an entity recognises an item as an intangible asset when the entity demonstrates that the item meets both the definition of an intangible asset and the recognition criteria in paragraphs 21–23 of IAS 38. IAS 38 defines an intangible asset as 'an

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identifiable non-monetary asset without physical substance'. IAS 38 notes that an asset is a resource controlled by an entity and paragraph 13 specifies that 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'.

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 IFRIC 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.

If an intangible asset is not recognised, how does the customer account for the configuration or customisation costs (Question II)?

If the customer does not recognise an intangible asset in relation to configuration or customisation of the application software, it applies paragraphs 68–70 of IAS 38 to account for those costs. The IFRIC observed that:

- a. the customer recognises the costs as an expense when it receives the configuration or customisation services (paragraph 69). Paragraph 69A specifies that 'services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service'. In assessing when to recognise the costs as an expense, IAS 38 therefore requires the customer to determine when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services.
- b. IAS 38 includes no requirements that deal with the identification of the services the customer receives in determining when the supplier performs those services in accordance with the contract to deliver them. Paragraphs 10–11 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors require the customer to refer to, and consider the applicability of, the requirements in IFRS Standards that deal with similar and related issues. The IFRIC observed that IFRS 15 Revenue from Contracts with Customers includes requirements that suppliers apply in identifying the promised goods or services in a contract with a customer. For the fact pattern described in the request, those requirements in IFRS 15 deal with issues similar and related to those faced by the customer in determining when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services.
- c. if the contract to deliver the configuration or customisation services to the customer is with the supplier of the application software (including cases in which the supplier subcontracts services to a third party), the customer applies paragraphs 69–69A of IAS 38 and determines when the supplier of the application software performs those services in accordance with the contract to deliver them as follows:

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- i. if the services the customer receives are distinct, then the customer recognises the costs as an expense when the supplier configures or customises the application software.
 - ii. if the services the customer receives are not distinct (because those services are not separately identifiable from the customer's right to receive access to the supplier's application software), then the customer recognises the costs as an expense when the supplier provides access to the application software over the contract term.
- d. if the contract to deliver the configuration or customisation services to the customer is with a third-party supplier, the customer applies paragraphs 69–69A of IAS 38 and determines when the third-party supplier performs those services in accordance with the contract to deliver them. In applying these requirements, the customer recognises the costs as an expense when the third-party supplier configures or customises the application software.
- e. if the customer pays the supplier of the configuration or customisation services before receiving those services, it recognises the prepayment as an asset (paragraph 70 of IAS 38).

Paragraphs 117–124 of IAS 1 Presentation of Financial Statements require the customer to disclose its accounting policy for configuration or customisation costs when that disclosure is relevant to an understanding of its financial statements.

The IFRIC concluded that the principles and requirements in IFRS Standards provide an adequate basis for a customer to determine its accounting for configuration or customisation costs incurred in relation to the SaaS arrangement described in the request. Consequently, the IFRIC decided not to add a standard-setting project to the work plan.