PUBLIC SECTOR ACCOUNTING DISCUSSION GROUP

Report on the Public Meeting

July 17, 2020

The Public Sector Accounting Discussion Group is a discussion forum only. The Group's purpose is to support the Public Sector Accounting Board (PSAB) by enabling discussion in a public venue of issues arising from the application of the CPA Canada Public Sector Accounting (PSA) Handbook, as well as emerging issues and issues on which the Board requests advice. The Group comprises members with various backgrounds who participate as individuals in the discussion. Any views expressed in the public meeting do not necessarily represent the views of the organization to which a member belongs or the views of the Board. The Group discussions do not constitute official pronouncements or authoritative guidance.

This document has been prepared by staff and is based on discussions during the Group's meeting.

Comments made in relation to the application of the PSA Handbook do not purport to be conclusions about acceptable or unacceptable application of the PSA Handbook. Only PSAB can make such a determination.

ITEMS PRESENTED AND DISCUSSED

Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service

In a cloud computing arrangement, a supplier provides the customer access to software that is not stored on hardware owned or physically located on the customer's premises. The software may be subject to a long-term licensing arrangement.

The submission focused the Group on accounting for implementation costs related to cloud computing arrangements that are service arrangements. In such arrangements, generally, the software is not customized. The provider has full control of and responsibility for maintenance and upgrades and the customer is prevented from retrieving the software on its own infrastructure. For such cloud computing arrangements that are service arrangements, customers need guidance as to the appropriate accounting under for related implementation costs.

The Group was asked to discuss two issues.

1. Should implementation costs be capitalized as an asset?
2. If implementation costs are capitalized,
   (a) should they be amortized; and
   (b) if so, should the amortization period consider any extension period(s)?

Issue 1

For Issue 1, the Group was asked to consider four views:

A. All implementation costs should be capitalized (using the general definition of an asset).

B. Implementation cost capitalization should be limited to amounts paid to third parties (the implementation costs would be considered a purchased intangible asset other than software).

C. Implementation costs can be capitalized based on the customer's software-capitalization policy (the implementation costs would be considered a software asset as the costs are necessary to activate external software).

D. All implementation costs should be expensed as incurred.

One Group member asked if the benefits related to the implementation costs were transferrable, should the entity change service providers. The submitter indicated that some arrangements are specific to a custom software solution or a provider. For other arrangements, the benefits of the implementation costs may be more transferable, perhaps by module. Another variable in determining transferability of benefits associated with implementation costs may relate to the data's portability from one provider to another.

The Group had mixed views on Issue 1. They were mainly divided between Views C and D. The debate rested on whether control of an asset could be demonstrated in relation to implementation costs incurred. A few Group members indicated that expensing the costs would occur because demonstrating control was not possible and, thus, the definition of an asset would not be met. They noted, however, that this result may not be appropriate given the materiality of investments in such arrangements.

Some Group members were concerned with recognizing implementation costs as an asset when the underlying software to which they relate is an asset of another entity (i.e., the underlying cloud computing arrangement is not capitalized by the customer, but instead is an asset of the provider). Still others concluded an asset did exist, by analogizing to leasehold improvements, or prepaid expenses. Some argued that the implementation costs were necessary to make use of the provider's software. Without incurring implementation costs to activate the computer solution, the cloud computing arrangement would be null. One Group member indicated that the location of the software should not negate the fact that significant costs may have been incurred to use it by the customer. Two Group members were more comfortable with recognizing as an asset only those implementation costs comprising purchases from third parties. This view leverages PSAB's 2019 proposals to allow recognition of purchased intangibles.

In addition, a few Group members indicated discomfort with implementation costs being a general rather than a specific asset.

Some Group members concluded it was possible to argue for each of the views, indicating a need for guidance in the standards, especially for intangibles.

Issue 2

Issue 2 built on Issue 1, asking if implementation costs are capitalized, should they be amortized? If so, should the amortization consider extension terms? Possible variations in arrangement terms included:

- Month-to-month agreement.
- Fixed five-year arrangement with a customer five-year extension option for a price to be determined at the time of the extension.
- Fixed five -year arrangement with a customer five-year extension option for a pre-set price.

Three views were considered:

A. The amortization period should be limited to the contractual term without consideration of extension options.

B. The amortization period should consider customer extension options included in the service contract.

C. The amortization period should consider potential extensions even in the absence of contractual extension option(s).

The submitter clarified that for the purposes of the discussion it should be assumed that the existence of contractual optional extensions (View B) or the intent by the customer to consider an extension beyond the contract term (View C) would be known on Day 1.

Most Group members concluded that View A was observable and controllable and supported by contract terms, but too conservative. It may, in effect, front-load amortization expense recognition. Nevertheless, one Group member reflected that the rate of change in software may mean that a change in arrangement is possible at the end of the initial period in the contract. Therefore, understanding the magnitude of the customer's investment in and commitment to the arrangement would be needed to justify amortization beyond the initial period in the contract.

Most agreed that View B was the most supportable approach. Several Group members referred to professional judgment in evaluating the substance of the contract for establishing the amortization period. Some Group members saw merit in View C but indicated there would be a burden of proof required as to why amortization should be extended beyond the contract terms. For example, the arrangement's size, if the benefits of the implementation costs are transferable to an arrangement with another provider and the customer's intent would be evaluated in ascertaining if amortization beyond contract terms is appropriate. One Group member also noted that the nature of the implementation costs capitalized, and the future economic benefits expected from them would also be considerations in determining if amortization beyond contract term(s) is appropriate. Useful life and the expectation of future benefits related to any implementation costs capitalized would need to be periodically assessed, as for any long-lived asset.

Another Group member noted that further implementation costs might need to be incurred to maintain the usefulness of the services in either a contractual or assumed extension period. This additional investment would be a factor considered in evaluating the extent to which future economic benefits will be realized from the initial implementation costs incurred.

One Group member noted that the accounting should not create a disincentive for such arrangements. Maintenance and upgrades will be required to ensure the services are provided as agreed and such arrangements tend to be material. So, at a minimum, any extensions in the contract should be considered in setting the amortization period for implementation costs capitalized (View B).

View C may be problematic as service providers will try to increase costs after the initial service period. So, assuming an extension that is not contractual in setting the amortization period may not be appropriate. There may be no financial reason to assume an extension beyond contractual term(s). For a month-to-month arrangement, the amortization period should be determined on Day 1 and regularly reassessed. Another Group member noted that while there may be a preference for specifics in contracts, information-technology costs are dropping. Locking in for fixed rates over set extension terms may mean costs are too high over time, but in return the customer gets consistent accounting over the contract term(s). Alternatively, there may be valid business reasons for choosing a month-to-month arrangement. In evaluating the feasibility of View C's approach, consideration should be given to the customer's expectations and past practices in changing cloud computing providers or arrangements.

Some Group members suggested that an intangibles standard would be useful in resolving the issues discussed. While the submission acknowledged PSAB's opening the door to recognizing purchased intangibles, a full standard on intangibles is needed. Two Group members suggested the Board reconsider the appropriateness of the existing inclusion of software as a tangible capital asset in TANGIBLE CAPITAL ASSETS, Section PS 3150.

Change in Control: First-time Consolidation of a Governmental Unit

ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, addresses situations in which a public sector entity acquires a governmental unit through a purchase by providing consideration. However, a public sector entity may have to apply consolidation accounting requirements after acquiring control of a governmental unit in a situation other than an acquisition. The submission set out a scenario in which a public sector reporting entity acquires control of another entity because of a change in the other entity's governance rules (as opposed to a reinterpretation of existing circumstances). For example, the reporting entity is now able to appoint a majority to the board of directors of the other entity. No consideration is exchanged. The change in governance is new information that impacts the reporting entity's assessment of the indicators of control in GOVERNMENT REPORTING ENTITY, Section PS 1300. The assessment concludes the entity is now controlled and is a governmental unit of the reporting entity. The newly controlled entity must be consolidated in the reporting entity's financial statements.

Standards do not explicitly deal with the accounting for this scenario. They merely recognize the possibility of an entity becoming eligible for inclusion in a reporting entity in the first sentence of BASIC PRINCIPLES OF CONSOLIDATION, paragraph PS 2500.07(e):

> Governmental units are included in government financial statements from the date of their creation or the date they became eligible for inclusion, and are removed from those financial statements from the date of their sale or other form of disposition or dissolution.

The submission made it clear that the consolidation is the result of new observable events that took place on a specific date, and not a review of the indicators of control that existed prior to that date. The scenario also indicated that the net value of the new governmental unit's assets and liabilities as at the date control changed is $5 million, which is material to the reporting entity's financial position.

The Group was asked to discuss two issues.

1. How should the impact of the initial consolidation of the newly controlled entity be recognized in the public sector entity's financial statements?
2. What should be the measurement basis for assets and liabilities subject to initial consolidation?

Issue 1

Regarding Issue 1, the Group considered three possible views:

A. Recognize a $5-million increase to the reporting entity's accumulated surplus as at the date control changed, without restatement of the financial statements of prior periods.

B. Recognize a restructuring transaction that gives rise to a $5-million revenue in the statement of operations as at the date control changed.

C. Recognize $5-million revenue for the accounting period in which the change in control occurred.

For Issue 1, the fair value and the carrying amount of the governmental unit's assets and liabilities were assumed to be equal.

In response to a Group member question, the submitter clarified that the newly controlled entity is assumed to continue its operations as before the change in control. Also, the reporting entity did not initiate the governance rule change that prompted the change in control. And it did not previously have the ability to initiate it.

Many Group members agreed that View A was most supportable; that it was a consolidation matter requiring an adjustment to accumulated surplus in Year 1 and consolidation adjustments thereafter. Two Group members also noted it as the more conservative option given that some specifics were not in the scenario. However, other Group members indicated that the PSA Handbook does not identify accumulated surplus or deficit as an element and only allows prior period adjustments in relation to changes in accounting policies or correction of errors or in scenarios meeting the description in the second sentence of paragraph PS 2500.07(e):

> If a governmental unit becomes eligible for inclusion as a result of a reinterpretation of existing circumstances, it would be included in the financial statements as if it had always been part of the government reporting entity. Such circumstances would, therefore, involve a restatement of comparative numbers.

A Group member noted it is important that the new governmental unit not be accounted for as if it has always been part of the reporting entity, as would be the case under View A and in the circumstances in the second sentence of paragraph PS 2500.07(e). There has clearly been a change in control, not a reassessment of existing factors.

Some Group members indicated that RESTRUCTURING TRANSACTIONS, Section PS 3430, did not apply to the scenario. They expressed concern that a specific transferor could not be identified as would seem to be required to apply Section PS 3430,[1] and that the scenario was not like an amalgamation,[2] also addressed the Section. However, one member questioned how the change in control occurred. Specifically, whether the change to the governance rules was decided by the former board of directors of the entity over which control was obtained. In such circumstances, the Group member thought the transaction would be more in the nature of a restructuring transaction. The former board of directors was making the decision and, thus, acting in the capacity of a transferor. Another Group member felt that a forced change in control could perhaps be analogized to an amalgamation of two local governments forced by the provincial government. Therefore, applying Section PS 3430 may best reflect the substance of the change in control.

Some Group members concluded that since the new governmental unit was expected to continue its operations unchanged after the change in control, then revenue recognition under View C is not appropriate. However, in line with the definition of revenue, other Group members noted that the reporting entity had experienced a net increase in economic resources because of the change in control and, thus, revenue recognition in the year control changed might best reflect the impact on the reporting entity.

In terms of suggestions to PSAB, Group members concluded that it would help to have clarity around the circumstances contemplated in the first sentence of paragraph PS 2500.07(e) (set out above) and direction on the appropriate accounting. Further, the Board could clarify if a transferor is required to apply Section PS 3430, or if it is possible to assume the existence of a transferor from the substance of certain change in control scenarios.

Issue 2

Issue 2 dealt with measurement. For Issue 2, the scenario was modified such that the carrying value of the assets and liabilities[3] of the new governmental unit are $5 million and their fair value $7.5 million. The Group was asked which measurement basis would apply at initial consolidation.

Building on their preferred views for Issue 1, most Group members agreed that using the carrying value was appropriate, especially when View A or B was considered the appropriate conclusion in Issue 1. A few Group members indicated that it would be illogical for there to be significant fair value adjustments in a situation in which no consideration was exchanged. However, some Group members supported

[1] Paragraph PS 3430.02(d).

[2] Paragraph PS 3430.02(a).

[3] The carrying value attributed to identifiable assets and liabilities carried at cost.

using fair value when View C was considered the appropriate conclusion in Issue 1 or by analogy to an acquisition or a contributed capital asset.[4] One Group member indicated that using fair value would provide a better cost of service for the governmental unit when using its assets in providing future services.

[4] TANGIBLE CAPITAL ASSETS, paragraph PS 3150.14.