



TE TAI ŌHANGA
THE TREASURY

Accounting for Software as a Service (SaaS)

Accounting guide for public sector entities, including
implications on appropriations for departments

February 2022

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About this guidance

This guidance document sets out the Crown accounting policy for the treatment of configuration and customisation costs in Software as Service (SaaS) arrangements, and the background that led to this change in accounting policy. This document also sets out the timing of application of this accounting treatment and for departments, the implications for budget authorisation and appropriations in relation to SaaS arrangements.

This guidance applies to all entities within the Government reporting entity that submit financial statements and forecast financial statements to the Treasury using Crown accounting policies (ie, departments, Crown entities, mixed ownership model companies and state-owned enterprises). However, Section 6 of the guidance, only applies to departments.

This guidance document should be read by Chief Financial Officers, those responsible for preparing financial statements and forecast financial statements in accordance with generally accepted accounting practice (GAAP), and those responsible for negotiation and management of SaaS contracts.

The requirements/guidance outlined in this document apply to Budget 2022 onwards and for the financial statements for the year ending 30 June 2022.

This document has been prepared by the Treasury and its issuance is supported by the Office of the Auditor-General and Audit New Zealand.

Questions and feedback

General enquiries about the information contained in this guidance, can be directed to angela.ryan@treasury.govt.nz or mark.mclellan@treasury.govt.nz

Any agency-specific questions should in the first instance be addressed to your Treasury Vote team (for departments) or Commercial Performance relationship manager (for Crown entities and SOEs).

Any comments as to how we could improve this guidance can be directed to angela.ryan@treasury.govt.nz

Further information

Other useful information and guidance on accounting for SaaS arrangements can be found on the websites of most medium/large accounting firms in New Zealand:

- https://www2.deloitte.com/content/dam/Deloitte/nz/Documents/audit/nz-en-Accounting-Alert-special-update-May-2021_26.05-v1.pdf
- <https://www.pwc.co.nz/pdfs/2021/in-depth-accounting-for-saas-arrangements-nov-2021.pdf>
- https://www.ey.com/en_gl/ifrs-technical-resources/applying-ifrs-accounting-for-cloud-computing-costs-july-2021
- <https://assets.kpmg/content/dam/kpmg/au/pdf/2021/21ru-016-cloud-arrangements-example-disclosures.pdf>
- <https://www.bdo.nz/en-nz/accounting-alert-may-2021/saas-implementation-costs-%E2%80%93-do-you-need-to-write-these-off-at-30-june-2021>

Scope of this guidance

The Treasury has received queries regarding the accounting treatment of Software as a Service (SaaS) arrangements, also known as cloud computing arrangements. The treatment of SaaS arrangements is not explicitly defined in NZ IFRS or Public Benefit Entity (PBE) standards. Consequently, to date individual interpretations have been required as each arrangement has been entered into.

However, in April 2021, the International Financial Reporting Interpretations Committee (IFRIC) released an agenda decision which provides authoritative guidance on how a customer accounts for configuration or customisation costs in relation to SaaS arrangements. This April 2021 agenda decision was built on the Committee's March 2019 agenda decision, where IFRIC considered whether a customer paying a fee in exchange for the right to receive access to the supplier's application software for a specified time receives a software asset at the SaaS contract commencement date or a service over the contract term.

This guidance includes background on the issue and the relevant IFRIC agenda decisions and:

- sets out the Crown accounting policy for the treatment of configuration and customisation costs of SaaS
- sets out the timing of the application of this accounting treatment, and
- for departments, sets out the implications for budget authorisation and appropriation matters in relation to SaaS arrangements.

1 SaaS Arrangements – background and history

Key takeaways:

- *Accounting for cloud computing arrangements and SAAS contracts, including the cost a customer incurs in getting the supplier's software ready for its intended use, is not addressed specifically in accounting standards, and inconsistent accounting treatments may have developed.*
- *Two IFRIC agenda decisions in March 2019 and April 2021 address possible inconsistencies in accounting for SaaS arrangements and associated configuration and customisation costs. These decisions may lead to an accounting policy change now for some entities.*

In SaaS arrangements, the cloud service provider typically provides public sector entities with access to their application software running on the provider's cloud infrastructure. The cloud infrastructure is a collection of hardware and software including networks, servers, operating systems, storage, and individual software capabilities. The public sector entity generally does not take possession of the software. Instead, the software is accessed on an as-required basis over the internet or via a dedicated line. The public sector entity does not manage or control the underlying cloud infrastructure. Contracts are often for an initial non-cancellable period, with options for the public sector entity to extend.

While the front-end appearance of a cloud model remains relatively consistent with a traditional on-premise software delivery model, there are distinct differences between the models.

A traditional on-premise model involves:

- the public sector entity purchasing hardware and application software licenses
- the application software being behind the public sector entity's firewall, and
- the public sector entity obtaining control over the intellectual property (IP).

A cloud model involves:

- the public sector entity having rights to access application software
- the application software being behind the cloud provider's firewall, and
- the cloud provider retains control over IP.

With traditional on-premise software arrangements, the public sector entity would likely have capitalised both the acquisition cost of application software and expenditure directly relating to getting the software asset operational. With a cloud computing arrangement, the public sector entity may no longer have an intangible (software) asset and therefore no longer be able to capitalise certain implementation expenses associated with the software. This is because the supplier provides and controls the IT infrastructure/software and the public sector entity acquires the right to access/use that infrastructure/software.

Nevertheless, it has often been considered in the past that some implementation costs associated with the cloud arrangement may be capitalised. These costs typically include configuring or customising the supplier's application software, defined as:

- (i) Configuration: Typical configuration relates to the setting of various 'flags' or 'switches' within the software, or defining certain values or parameters, to implement a particular set-up for the software's existing functionality. Configuration does not involve the modification or writing of additional software code, but rather involves setting up the software's existing code to function in a particular way for the entity's benefit.
- (ii) Customisation: Typical customisation involves modifying existing software code in the application or writing additional code. The effect of significantly altering or adding software code is generally to change, or create additional, functionalities within the software so that it can provide the intended benefits.

The logic has been that these configuration and customisation activities on the cloud service provider's software, paid for by the public sector entity in the application development stage, have delivered an asset that the public sector entity will benefit from, through future economic benefits or service potential under the contract, and therefore, the public sector entity can report an intangible asset for the upfront configuration and customisation costs under their interpretation of PBE IPSAS 31 *Intangible Assets*.

Because of the professional judgement involved, accounting treatments for configuration and customisation costs of the supplier's application software until now have been individually assessed and agreed with auditors. This opens the possibility of inconsistent treatments and so the issue has recently been considered by IFRIC.

IFRIC agenda decisions

Two IFRIC agenda decisions have been released, which focus on how customers should account for the costs of software provided by a supplier in a SaaS arrangement. The full agenda decisions are provided in Appendix Two.

The 2019 agenda decision deals with whether fees paid in exchange for access to the supplier's application software in a SaaS arrangement give rise to an intangible asset or is a service contract.

The 2021 agenda decision deals with the accounting treatment of the costs an entity incurs in customising or configuring the supplier's application software in a SaaS arrangement.

While the decisions of the committee do not directly impact PBE standards, which are mainly based on IPSASs¹, given that NZ IAS 38 *Intangible Assets* and PBE IPSAS 31 are similar, IFRIC's conclusions are authoritative support and may be considered under GAAP. As a result, the agenda decisions will be applied in Crown accounting policy.

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 in respect of SaaS.

¹ International Public Sector Accounting Standards

2 SaaS Arrangements – service or an asset?

Key takeaways:

- *The 2019 IFRIC agenda decision covers fees paid in exchange for a right to receive access to a supplier's application software.*
- *If a contract conveys to the customer only the right to receive access to the supplier's application software in the future, the contract neither contains a software finance lease under PBE IPSAS 13, nor an intangible software asset under IPSAS 31, but rather is a service the customer receives over the contract term.*
- *We consider the key issue for entities will usually be whether the arrangement with the SaaS provider includes an intangible asset rather than a finance lease. We think finance leases for software in SaaS arrangements will be rare.*
- *Fees associated with only the right of the access to the software in a SaaS arrangement are viewed as payments for services and are expensed as incurred (generally over the term of arrangement).*
- *Where an entity receives rights beyond a right of access, this could indicate an entity has an intangible asset. SaaS arrangements with substantial customisation to the "off the shelf" version or that are bespoke to the entity are where the existence of an intangible asset is more likely.*
- *The customer must evaluate the underlying contract carefully and consider (and document) all the relevant facts and circumstances to determine if any separate intangible software asset exists at the inception of the SaaS arrangement for substantive rights beyond a right of access.*

Before looking at the April 2021 IFRIC agenda decision in respect to configuration and customisation costs, we recap the first IFRIC agenda decision in March 2019.

The guidance in this section only relates to the "base" fees paid to a SaaS provider to access their application software. It does not cover any additional charges that may arise for customising or configuring the base SaaS solution provided. Such costs are covered in Section 3.

In 2019, IFRIC considered whether a customer paying a fee in exchange for the right to receive access to the supplier's application software for a specified time receives a software asset at the contract commencement date or a service over the contract term.

A customer receives an asset at the contract commencement date if either (a) the customer otherwise obtains control of the software at the contract commencement date (ie, an intangible asset) or (b) the contract contains a software lease under the new international leasing standard IFRS 16 (ie, contains a “right-of-use” asset).²

Intangible asset

Both NZ IAS 38 and PBE IPSAS 31 define an intangible asset as ‘an identifiable non-monetary asset without physical substance’³. They discuss that an asset is a resource controlled by the entity and that an entity controls an intangible asset if it has the power to obtain the future economic benefits or service potential flowing from the underlying resource and to restrict the access of others to those benefits.

In respect of whether an intangible asset arises, IFRIC took the view that if a SaaS contract conveys to the customer only the right to receive access to the supplier’s application software over the contract term, the customer does not receive a software intangible asset at the contract commencement date.

A right to receive future access to the supplier’s software does not, at the contract commencement date, give the customer the power to obtain the future economic benefits flowing from the software itself and to restrict others’ access to those benefits and therefore, the asset control test is not met.

This lack of control is because the SaaS provider usually holds, manages, and updates the SaaS application software over the period of the arrangement. This is expected to be the case for most “off the shelf” SaaS arrangements.

However, where the customer receives rights beyond a right of access, this could indicate a customer has an intangible asset. Some factors that can indicate the customer has control of an intangible asset include:

- The contract sets out that software or intellectual property is owned by the customer or the customer has exclusive rights to the software.
- When the version of the software modified for the customer can only be used by the customer (eg, the contract specifies that the vendor cannot make the software available to other customers).
- When the customer has the right to possess a copy of the software (without a significant penalty), and it is feasible for the client to run the software on its hardware or an unrelated supplier of its choice.
- Where the software passes to the customer on contract termination.

² The new international lease standard, IFRS 16 (which in New Zealand currently only applies to for-profit entities reporting in accordance with NZ IFRS) sets out the definition of a lease and a key element is that the contract must convey a right to use an asset. IFRS 16 explains that the right to use an asset, throughout the period of use, is where a customer has both: (a) the right to obtain substantially all the economic benefits from use of the identified asset and (b) the right to direct the use of that asset – for example, decision-making rights to change the asset and for what purpose the asset is used.

³ Refer to PBE IPSAS 31:16-25. Control is defined as the power to derive future economic benefits for more than a year, and to restrict the access of others to those benefits [IPSAS 31:21-24]. To recognise an asset, the future economic benefits of the entity is probable, and the cost of the asset can be measured reliably. [PBE IPSAS 31:28-31]

- The customer manages when the modified software is reconfigured/updated, rather than the SaaS provider controlling when this is done.
- The customer has control over the infrastructure on which the software is hosted.

SaaS arrangements with substantial customisation to the “off the shelf” version or that are bespoke to the entity are those more likely to include an intangible asset. The underlying contractual documentation will need to be closely reviewed.

If fees associated with the access to the software of a SaaS arrangement are not an intangible asset they are viewed as payments for services and are expensed as incurred (generally over the term of the arrangement).

If the fees associated with the access to the software of a SaaS arrangement give rise to an intangible asset, then the customer will need to record the intangible asset at its cost. This will give rise to an asset and liability (if not paid for upfront) for the intangible asset component of the payments.

Software lease

Public sector entities applying PBE accounting standards should consider IPSAS 13 *Leases*, rather than NZ IFRS 16 *Leases* when determining whether a SaaS arrangement contains a lease asset or not.

Under PBE IPSAS 13 a lease is classified as either an operating lease or a finance lease. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. An operating lease is a lease other than a finance lease.

NZ IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. The new lease standard eliminates the operating and finance lease classification for lessees and introduces a new “right-of-use” asset for all lease contracts. NZ IFRS 16 is only applicable to entities reporting under NZ IFRS accounting standards.

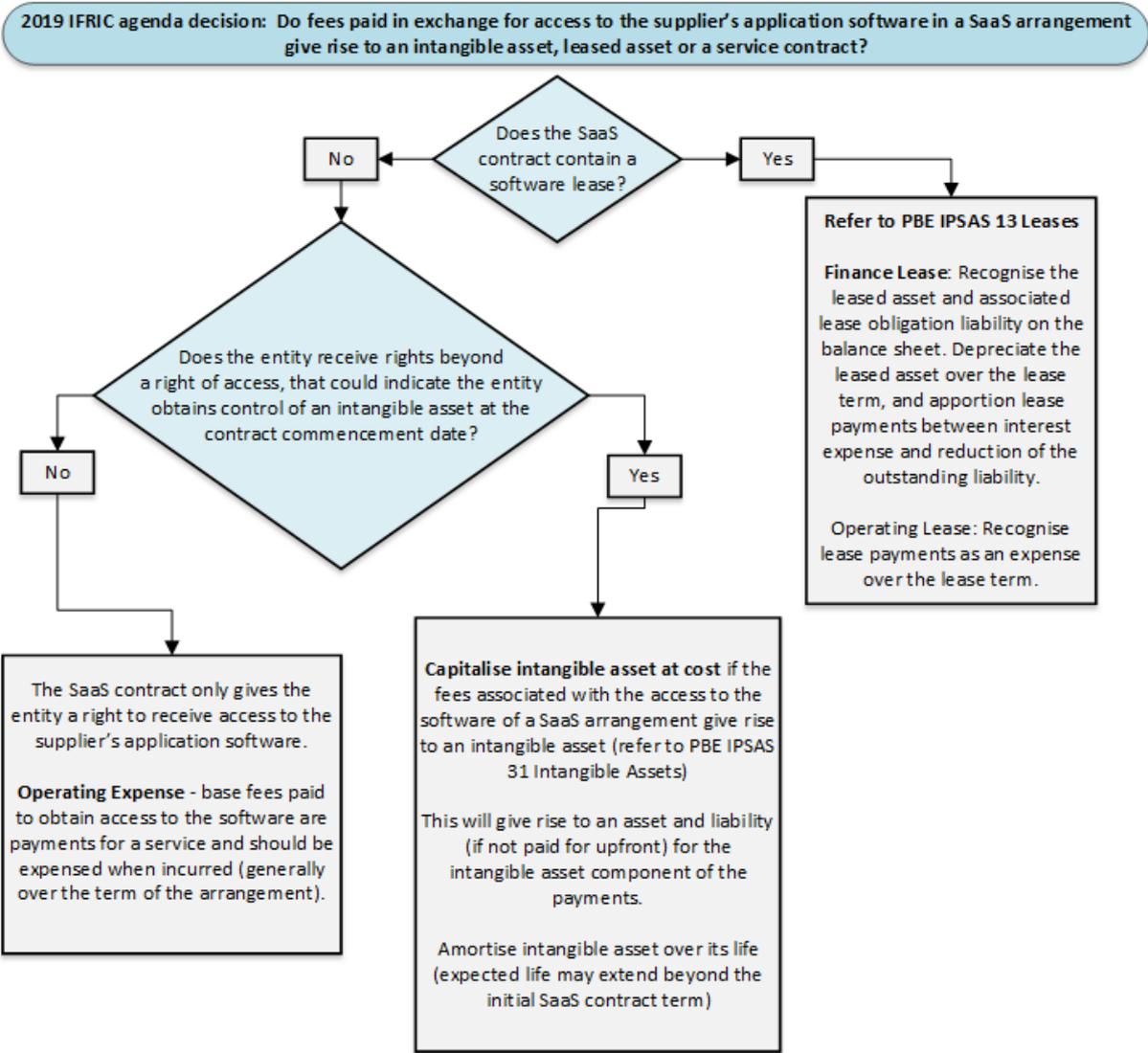
In assessing whether a software lease asset under IFRS 16 arises, IFRIC stated that a right to receive future access to the supplier’s software running on the supplier’s cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used – the supplier would have those rights by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run. Accordingly, if a contract conveys to the customer only the right to receive access to the supplier’s application software over the contract term, the contract does not contain a software lease.

We have concluded that this IFRIC discussion can be applied by analogy to finance leases in PBE IPSAS 13 because finance leases give rise to in-substance assets controlled by the lessee under a risks and rewards model. As a result, public sector entities should consider whether there is a finance lease under PBE IPSAS 13 as part of their SaaS arrangements. A contract contains a finance lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Control under a finance lease (using a risk and rewards perspective) means 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 the customer can direct the use of that asset.

While the 2019 agenda decision includes discussion on whether a SaaS arrangement contains a lease, we consider the key issue for entities will usually be whether the arrangement with the SaaS provider includes an intangible asset.

Entities must evaluate the underlying contract carefully and consider (and document) all the relevant facts and circumstances to determine if any separate intangible asset or software lease exists at the inception of the SaaS arrangement.

Figure 1: The 2019 IFRIC agenda decision flow diagram



3 Configuration and customisation costs – operating expense or intangible asset?

The IFRIC's second agenda item in April 2021 deals specifically with configuration and customisation costs incurred in implementing SaaS arrangements. IFRIC firstly considered whether the customer recognises an intangible asset in relation to configuration or customisation costs of the application software, and secondly, if an intangible asset is not recognised, how the customer accounts for the configuration or customisation costs.

3.1 Does the customer recognise an intangible asset for configuration or customisation of the application software (Question I)?

Key takeaways:

- *In SaaS arrangements, configuration and customisation activities are commonly paid for by the customer and performed on the internal infrastructure and software applications of the cloud service provider prior to the hosting period commencing.*
- *If the SaaS arrangement conveys to the customer only the right to access the supplier's application, the customer would not recognise an intangible asset for the cost it incurred in relation to the configuration and customisation of the supplier's application software (on the presumption that the customer does not control the supplier's application software being configured or customised, the supplier does).*
- *If the configuration and customisation activities are paid for by the customer and are performed on the customer's infrastructure and applications, (ie, behind the customer's firewall), or creates separately identifiable customer-controlled software located behind the SaaS provider's firewall, these costs may represent a resource of the customer that meets the definition of an intangible asset in PBE IPSAS 31.*
- *Public sector entities should consider each stage of a software implementation project and the nature of each category of project cost incurred to determine whether they control an asset under PBE IPSAS 17 Property, Plant and Equipment or PBE IPSAS 31 Intangible Assets or whether those project costs are treated as expenses.*
- *If the customer controls the software in the SaaS arrangement and is recognising an intangible asset for the SaaS (refer Section 2), then the configuration and customisation costs of that software should also be capitalised as an intangible asset.*
- *This is a complex area and finance teams will need to work closely with IT teams and SaaS service providers to understand contractual rights in relation to configuration and/or customisation of SaaS arrangements. A public sector entity should also work closely with their auditors when determining the agency's accounting capitalisation policy for cloud computing arrangements, including SaaS implementation.*

Configuration involves the setting of various ‘flags’ and ‘switches’ within the SaaS 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 SaaS software code in the application or writing additional code; it generally changes, or creates additional, functionalities within the software.

The assessment of whether configuration and customisation of the application software results in an intangible asset depends on the nature and output of the configuration and customisation performed.

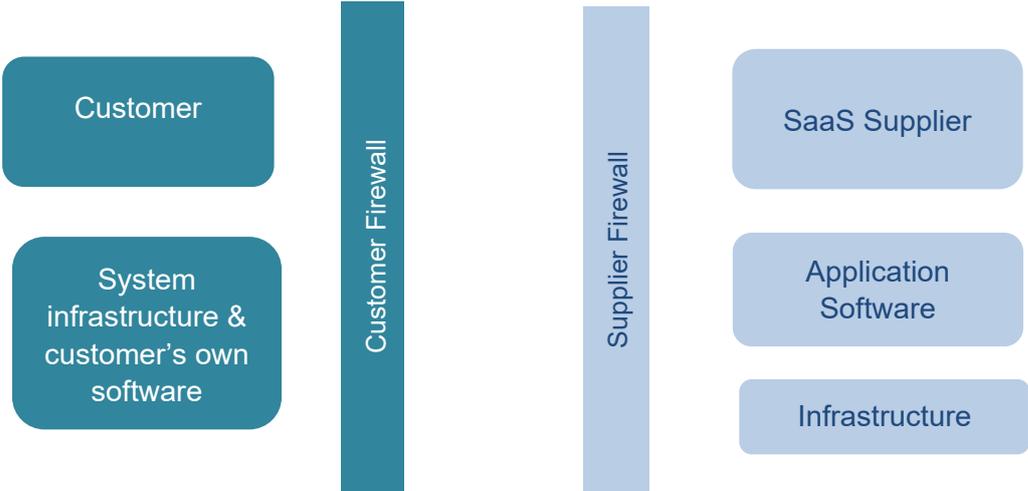
If the entity does not control the supplier’s software of the SaaS arrangement (as discussed in Section 2) then usually the entity would not have an intangible asset in relation to configuration and customisation costs of the supplier’s software. This is because those costs generally will not create a resource controlled by the entity that is separable from the supplier’s software.

A key question for IFRIC was whether the configuration and customisation activities create a resource controlled by the customer that is separate from the cloud software. IFRIC observed that only where the configuration and customisation costs results 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, would it be possible to assess that the additional code is identifiable and meets the recognition criteria in PBE IPSAS 31 in determining whether to recognise the additional code as an intangible asset (refer Section 2 for the definition of an intangible asset).

In SaaS arrangements, configuration and customisation activities are commonly performed on the internal infrastructure and software applications of the cloud service provider. In this situation, typically, the customer’s access to the benefits of the configuration and customisation activity in this situation is only through the right to receive access to the supplier’s application software, where the supplier controls the software resource.

In contrast, if the configuration and customisation activities are performed on the customer’s infrastructure and applications in preparation of the SaaS arrangement, (ie, behind the customer’s firewall), these costs could meet the definition of an intangible asset where there is a transfer of control of the resource to the customer, and where that resource enhances and improves the customer’s existing on-premise software asset. In this situation, the customer is likely to control the software resource, which includes customisation and configuration costs, if they meet the definition of an intangible asset, and could restrict the access of others to the asset’s benefits. Figure 2 provides a simplified illustration of this scenario.

Figure 2: SaaS arrangement which conveys to the customer only a right to access the SaaS application software



Implementation Activities

Costs incurred to configure or customise application software controlled by the customer could be capitalised as an intangible asset if they meet the definition of an intangible asset in PBE IPSAS 31

Costs incurred by the customer to configure or customise the application software controlled by the supplier are not capitalised as an intangible asset

In some instances, costs incurred by the customer give rise to customised software assets located behind the SaaS provider firewall that the customer controls

However, additional software or code created for a customer, where the customer has the power to obtain future benefits, and to restrict others access to those benefits could be located behind the SaaS provider’s firewall and therefore, may meet the definition of an intangible asset. That is, while the software as a whole may not be controlled, a component of it (ie, the specific code developed for the customer) or a separate piece of software developed as part of the implementation project may be controlled by the customer and require recognition as an intangible asset. Examples of this may be:

- Applications, modules or code developed and controlled by the client that are integrated with the SaaS product (regardless of who hosts the applications developed).
- Bridging modules and modifications to exiting on-premise software to enable communication between on-premise existing software controlled by the client and the SaaS service.

The fact that such intangible assets may only be of use to the entity together with the supplier’s software in the SaaS arrangement is irrelevant in assessing whether there is an intangible asset.

Case Study – Customised software (intangible asset) located behind the SaaS provider’s firewall

Customised software code is being built by a third-party supplier solely for Entity A’s use. The code is typically a login screen to a set of forms and workflow for authenticated external users/organisations to interact with Entity A – requesting or entering information and receiving data back.

The developed code will run on the SaaS provider’s platform in the Cloud. The code is owned, maintained and updated by Entity A. However, the underlying SaaS provider’s platform components are owned, maintained and updated by the provider, and used by many other provider’s customers worldwide. The application developed by Entity A is maintained by Entity A or its authorised sub-contractors and is used only by those internal and/or external users that Entity A allows.

Accounting Treatment:

Entity A is the owner of the custom code and controls it, as Entity A decides if, and when to update the code and other SaaS provider’s customers (except for Entity A’s external users) are not able to use or access the code. Entity A also expects to receive future economic benefits from using the code. Consequently, Entity A plans to capitalise the costs to build the customised code as they meet the intangible asset recognition requirements under PBE IPSAS 31.

Entity A will pay the SaaS Provider a subscription charge for use of the SaaS platform which will be treated as an operating cost of Entity A.

If a customer pays the supplier (or the supplier’s subcontractor) for configuration and customisation services upfront, and the costs do not give rise to an intangible asset, those costs may be required to be expensed when incurred or expensed over time (through recognising a prepayment asset). Determining which of these expense options should be applied is discussed in Section 3.2 below.

Entities should carefully review all the relevant facts and circumstances and contractual documentation in making (and documenting) their judgements about whether configuration and customisation costs could be capitalised as intangible assets.

Other implementation costs

While the April 2021 IFRIC agenda decision addressed specifically the costs incurred by the customer in respect of configuration and customisation of the supplier’s application software, the customer is likely to incur other implementation costs in relation to a SaaS arrangement.

Other implementation costs can include research costs (e.g. needs assessment and software evaluation), hardware costs, training costs, data conversion and testing. Customers need to carefully evaluate these types of expenditure and determine whether the costs should be expensed or capitalised in accordance with PBE IPSAS 17 and/or PBE IPSAS 31. This will depend on whether such expenditure relates to the supplier’s application software or whether it gives rise to a separate customer asset, identifiable and controlled by the customer or it enhances an existing asset of the customer. It also depends on the nature of the expenditure itself. For example, data conversion activities and research in evaluating software options are unlikely to ever meet the definition of an intangible asset in PBE IPSAS 31, regardless of whether a SaaS arrangement is involved or not. However,

costs to test software will depend on the nature of the testing. For example, testing of customer on-premise bespoke software may be able to be capitalised, but testing of supplier’s application software under a SaaS arrangement, where the SaaS contract conveys to the customer only a right of access, will not be able to be capitalised as an intangible asset.

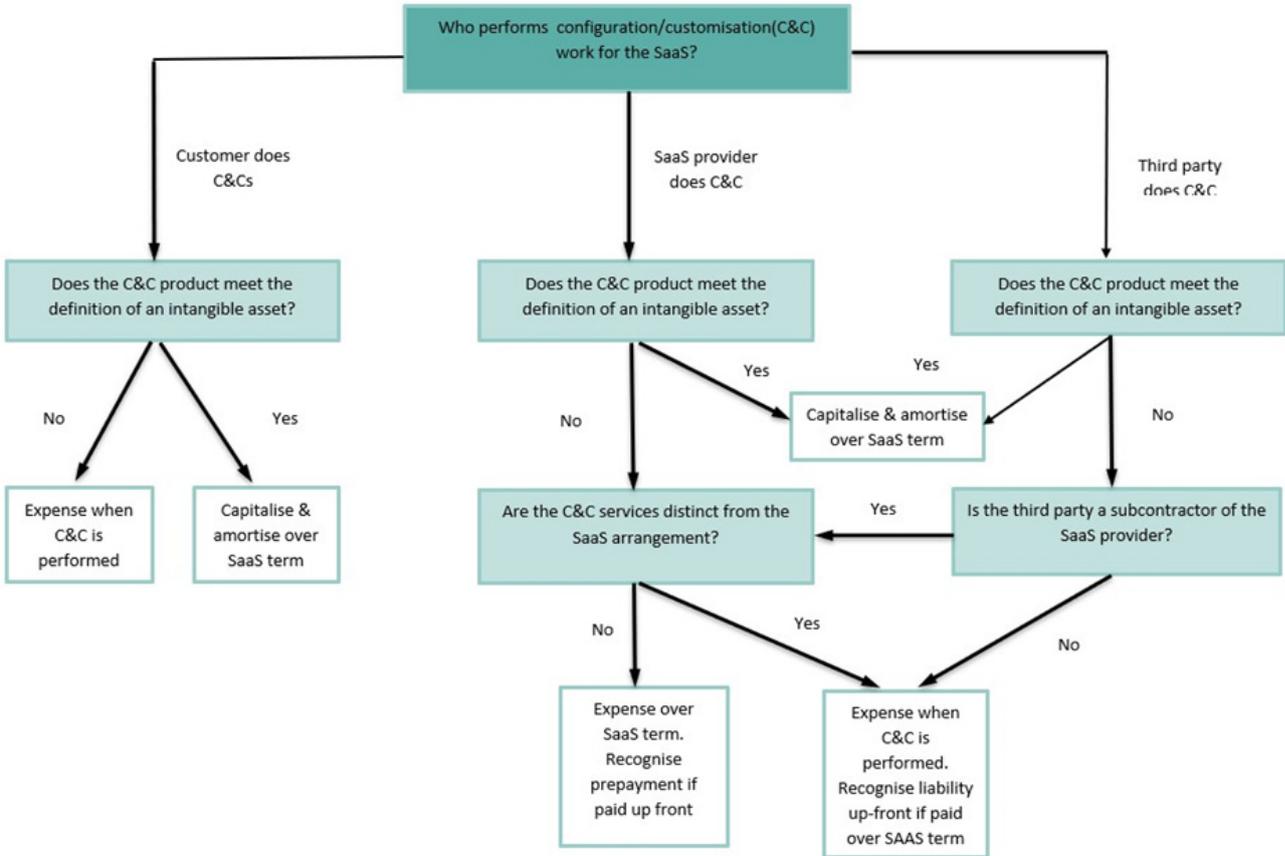
The topic of broader implementation costs in IT projects and what can be capitalised for financial reporting is outside the scope of this guidance. It is a complex area and finance teams will need to work closely with IT teams to determine the accounting treatment of implementation costs associated with cloud computing arrangements. Guidance on accounting for cloud computing arrangements and implementation cost can also be found on the website of most medium/large accounting firms in New Zealand (refer to the [About this guidance](#) section for the relevant website links).

We also recommend that public sector entities work closely with their auditors when determining the entity’s accounting capitalisation policy for cloud computing arrangements.

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

If the SaaS has been assessed as not an intangible asset of the customer, then the IFRIC’s 2021 decision applies as follows:

Figure 3: The 2021 IFRIC agenda decision flow diagram



Key takeaways:

- *If the SaaS arrangement does not provide a customer with control of the configuration and customisation asset, then any related internal or external costs paid to a third party (not subcontracted by the SaaS provider) are expensed as incurred when the configuration and customisation services are performed.*
- *However, configuration or customisation costs paid to a SaaS provider or a third party subcontracted by the SaaS provider could either be:*
 - *expensed when incurred (usually upfront when the customisation or configuration work is undertaken and completed), or*
 - *expensed over the expected service period of the SaaS arrangement, with a prepayment asset recognised if the costs are paid for upfront.*

This expense treatment depends 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 recognised as a prepayment asset, and subsequently expensed over the expected service period in the SaaS contract . Consideration should also be given to the classification of this prepayment as current or non-current.*
- *Prepaid costs would be released as an expense over the period that the entity expects to benefit from such expenditure. The expected SaaS service term might be beyond the initial SaaS contractual term.*
- *If the conclusion is that the delivery of the configuration and customisation service is distinct, costs (paid to the SaaS provider, or a third party) for customisation or configuration, would be expensed as incurred (usually upfront).*

A supplier of the configuration and customisation services could be the SaaS provider or subcontractor (agent) of the SaaS provider, a third party to the customer (and SaaS supplier), or employees or in-house contractors of the customer. The timing of when to recognise the costs as an expense will require the customer to determine the nature of the contract terms and when the supplier provides the configuration or customisation services.

If the configuration and customisation to the SaaS provider's asset are provided by the customer, or its contractors, those costs are expensed as they are incurred.

However, if the configuration and customisation work is provided by the SaaS provider, or their subcontractor, further analysis of the costs is required to determine if they should be:

- expensed as the configuration and customisation costs are incurred (usually upfront when the customisation or configuration work is undertaken and completed), and recognising a liability if the costs are paid for over the term of the arrangement), or
- expensed over the expected service term of the SaaS arrangement as configuration and customisation service are
- over time by the customer (including reporting a prepayment asset if costs are paid upfront).

A third party may in substance be a subcontractor of the supplier. For example, this may be the case if:

- The supplier has some say or instructs how the work by the 3rd party is performed.
- There is a tripartite agreement between the client, supplier, and third party.
- If the supplier identified the specifications and scope of work by the third party.
- The supplier is primarily responsible for the services the third party performs.

Entities will need to understand the relationship between the various parties that perform configuration and customisation services if they are not solely performed by the entity or the supplier, especially when the configuration and customisation costs are material.

Expensed over the SaaS service period (with prepayment asset if paid up front) versus expensed when incurred

The IFRIC agenda decision explains the distinction between expenses as incurred (usually upfront) when the customisation or configuration work is undertaken versus expenses that are spread over the service period of the SaaS arrangement. The expense decision is made by assessing whether the configuration and customisation services delivered to the customer are distinct (as per NZ IFRS 15 Revenue from Contracts with Customers) from the SaaS access service or not.

PBE IPSAS 9 *Revenue from Exchange Transactions* does not include specific guidance on whether a transaction has more than one component. Notwithstanding this, we consider PBEs can apply this "distinct" concept for assessing when configuration and customisation services are delivered to the entity in the absence of specific requirements in PBE standards. Also, while NZ IFRS 15 is a revenue accounting standard for sellers to apply in their financial statements, the principles and guidance from NZ IFRS 15 in relation to distinct versus non-distinct goods and services are applicable to determining a customer's SaaS accounting policy for configuration and customisation costs.

For configuration and customisation related costs that are paid upfront (as opposed to payments throughout the service term), if the configuration and customisation services received by the customer are distinct from the receipt of SaaS access services, then the configuration and customisation costs are expensed as incurred. Otherwise, if configuration and customisation services delivered to the customer are not distinct from the delivery of

the SaaS access services, the upfront payments are recognised as a prepayment asset and are expensed over the expected service period of the SaaS arrangement.

To determine whether promised goods or services are separately identifiable in accordance with NZ IFRS 15 (ie, whether a promise to transfer a good or service is distinct within the context of the contract), sellers need to evaluate whether their promise is to transfer each good or service individually or a combined item (or items) that comprises the individual goods or services promised in the contract. Therefore, sellers must evaluate whether the promised goods or services in the contract are outputs or whether they are inputs to a combined item (or items). In the Basis for Conclusions of IFRS 15, the IASB noted that, in many cases, a combined item (or items) is more than (or substantially different from) the sum of the underlying promised goods or services.

NZ IFRS 15.29 includes the following three factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable and, therefore, need to be combined into a single performance obligation:

- The seller provides a significant service of integrating goods or services with other goods or services in the contract.
- One or more goods or services significantly modifies or customises other goods or services in the contract.
- The goods or services in the contract are highly interdependent or highly interrelated.

In the Basis for Conclusions of IFRS 15, the IASB noted that these three factors are not an exhaustive list and that not all of the factors need to exist in order to conclude that the entity's promises to transfer goods or services are not separately identifiable.

The evaluation of whether a promised good or service is separately identifiable requires a thorough understanding of the facts and circumstances present in each contract. Customers should consider the following questions, which summarise the factors discussed in the Basis for Conclusions of IFRS 15:

- Is the combined item greater than, or substantively different from, the sum of the promised goods or services?
- Is the seller, in substance, fulfilling a single promise to the customer?
- Is the risk the seller assumes to fulfil its obligation to transfer a promised good or service inseparable from the risk relating to the transfer of the other promised goods or services in the bundle?
- Do two or more promised goods or services each significantly affect the other?
- Does each promised good or service significantly affect the other promised good or service's utility to the customer?

The second factor in NZ IFRS 15.29(b) is the presence of significant modification or customisation, which may be particularly relevant for certain implementation services in a cloud computing service arrangement. In the Basis for Conclusions the IASB explained that, in some industries, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customises another. This is because, if a good or service modifies or customises another good or service in a contract, each good or service is being assembled together (as an input) to produce a combined output.

In the Basis for Conclusions on IFRS 15, the IASB provided the following example from the perspective of the seller:

Example of significant customisation service

Assume that an entity promises to provide a customer with software that it will significantly customise to make the software function with the customer's existing infrastructure. Based on the facts and circumstances, the entity determines that it is providing the customer with a fully integrated system and that the customisation service requires it to significantly modify the software in such a way that the risks of providing it and the customisation service are inseparable (ie, the software and customisation service are not separately identifiable).

The significance of modification or customisation services can affect an entity's conclusion about the number of identified performance obligations for similar fact patterns.

Taking this guidance, the following are indicators that the configuration and customisation services delivered are **not** distinct from the delivery of SaaS access services and the expense should be spread over the term of the SAAS arrangement:

- The configuration and customisation services significantly modify the functionality, features or service that will be provided.
- The configuration and customisation services require specialised skill sets that the customer or other third parties cannot provide.
- The configuration and customisation services and access and ongoing operation of the SaaS are highly dependent on each other.

The following are indicators that the configuration and customisation services are distinct, and the expense should be recognised as the configuration and customisation are performed:

- The configuration and customisation services are straight forward and could be provided by other parties contracted by the customer (ie, the customer could benefit from the SAAS without obtaining configuration and customisation services from the supplier).

Significant customisations to the software are less likely to be distinct from the SaaS access service than more straight forward configuration services.

Example where delivery of configuration and customisation services are not distinct

An entity requires the base solution for a SaaS platform to have further functionality added for a client relationship management system which will contribute to it fulfilling its service delivery objectives. This requires the SaaS service provider to modify the base code and add further functionalities (such as reporting and communication tools) and develop new data fields to allow the customer to collect certain client information. The costs for this customisation are paid for upfront by the customer.

In this example, the configuration and customisation are not distinct because they significantly modify the services that will be provided by the supplier and enable the entity to meet its service delivery objectives. The prepayment for configuration and customisation costs gives the customer a right to future service and is therefore, an asset (ie, a payment in advance) for the customer at the time it is paid. These configuration and customisation costs shall be recognised as a prepayment and be expensed over the expected service period. Note the expected service period also needs careful consideration and might be beyond the initial SAAS contract term.

4 Crown accounting policy for SaaS arrangements

Key takeaways:

- *As a result of the IFRIC agenda decision in April 2021, the Crown accounting policies have been updated for costs incurred by a public sector entity for configuration and customisation of a supplier's application software in a SaaS arrangement.*
- *The Crown accounting policy is outlined in this section (refer below).*
- *A public sector entity's existing capitalisation policy in relation to configuration and customisation costs of SaaS arrangements may now be inconsistent with the updated Crown accounting policy and as a result, the entity may need to consider the impact of this update on their own accounting policies and their financial statements.*

Following the IFRIC agenda decisions in March 2019 and April 2021, the Crown accounting policy is as follows.

Fees to access the supplier's application software in a SaaS arrangement

Where the SaaS contract only gives a public sector entity a right to receive access to the supplier's application software, that access in the SaaS arrangement would usually not give the entity an intangible asset due to lack of control over an identified asset. This is because the SaaS provider usually holds, manages, and updates the SaaS application software over the period of the arrangement. This is expected to be the case for most "off the shelf" SaaS arrangements.

However, where a public sector entity receives rights beyond a right of access, this could indicate a customer has an intangible asset or the arrangement contains a finance lease.

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is a resource controlled by the entity and an entity controls an intangible asset if it has the power to obtain the future economic benefits or service potential flowing from the underlying resource and to restrict the access of others to those benefits.

Under PBE IPSAS 13 a lease is classified as either an operating lease or a finance lease. A finance lease⁴ is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. An operating lease is a lease other than a finance lease.

If fees associated with the access to the software of a SaaS arrangement do not give rise to an intangible asset or finance lease, they are viewed as payments for services and are expensed as incurred (generally over the term of arrangement).

⁴ Finance leases are defined as borrowings under the Public Finance Act (PFA) 1989. Under the Act, departments are prohibited from borrowing (except from, or within, the Crown), issuing securities, entering derivatives transactions and lending. However, the Minister of Finance may perform these activities on behalf of departments, subject to certain restrictions

If the fees associated with the access to the software of a SaaS arrangement give rise to an intangible asset, then a public sector entity will need to record the intangible asset at its cost. This will give rise to an asset and liability (if not paid for upfront) for the intangible asset component of the payments.

If the fees associated with the access to the software of a SaaS arrangement give rise to a finance lease, then entities should apply lessee accounting from PBE IPSAS 13 *Leases*.

Configuration and customisation costs related to SaaS

If a public sector controls the software in the SaaS arrangement and is recognising an intangible asset for the SaaS (refer section above), then the configuration and customisation costs of that software should also be capitalised as an intangible asset.

If the SaaS has been assessed as not an intangible asset of a public sector entity or a finance lease, then IFRIC's 2021 decision applies. The agenda decision states that there are three ways of accounting for configuration and customisation costs, and provides criteria when each of these options should be applied:

- Capitalised as an intangible asset and amortised over the life of the asset.
- Expensed when incurred (usually incurred upfront).
- Expensed over the term of the SaaS arrangement, with a prepayment (asset) recognised if paid upfront.

If the configuration and customisation to the SaaS provider's application software are performed by the public sector entity, or its contractors, those costs are expensed as they are incurred, unless the costs give rise to a configuration and customisation product and the criteria for recognising it as a separate intangible asset are met.

However, if the configuration and customisation work is performed by the SaaS provider, or their subcontractor, further analysis of the costs is required to determine if they should be:

- expensed as the configuration and customisation services are incurred (usually upfront), and recognising a liability if the costs are paid over the term of the arrangement, or
- spread over the term of the SaaS arrangement (recognising a prepayment if paid upfront).

The distinction between expense as incurred versus spread over the term of the arrangement is made by assessing whether the configuration and customisation services delivered to the customer are distinct (as per NZ IFRS 15 *Revenue from Contracts with Customers*) from the SaaS access service.

For configuration and customisation related costs that are paid upfront (as opposed to payments throughout the service term), if the configuration and customisation services delivered to the customer are distinct from the delivery of the SaaS access services, then they are expensed as incurred. Otherwise, if configuration and customisation services delivered are not distinct from the delivery of the SaaS access services, they are recognised as a prepayment and are expensed over the expected service term of the SaaS arrangement. The expected SaaS service term might be beyond the initial SaaS contractual term.

This is a complex area of accounting and finance teams will need to work closely with IT teams and potentially service providers to understand and document contractual rights in relation to configuration and/or customisation services.

Most medium/large accounting firms have also provided guidance and examples on this topic, which entities may find useful (refer to the [About this guidance](#) section for the relevant website links). We also recommend that agencies work closely with their auditors when determining the public sector entity's accounting capitalisation policy for cloud computing arrangements.

5 Application date of accounting policy change

Key takeaways:

- *Where a public sector entity's current capitalisation policy for SaaS arrangements is materially inconsistent with the updated Crown accounting policy for configuration and customisation costs, owing to IFRIC's agenda decision in April 2021, the entity will need to change their existing accounting policy.*
- *A change in accounting policy, where the impact is material, is applied retrospectively as if the entity had always applied the new policy, except to the extent it is impracticable to do so.*
- *If the impact of the change in accounting policy is not material, the accounting policy does not need to be applied retrospectively and comparatives presented in the next set of financial statements do not need to be restated.*
- *Public sector entities should work with their auditors to agree on the proposed approach to any accounting policy change in relation to configuration and customisation costs incurred in SaaS arrangements.*
- *Entities within the Government reporting entity that submit five-year fiscal forecasts to CFISnet (departments and A and B stream Crown entities and state-owned enterprises) should estimate and include the impact of the updated accounting policy for SaaS arrangements in their forecast financial statements as part of Budget 2022.*

Where a public sector entity's current capitalisation policy for SaaS arrangements is inconsistent with the updated Crown accounting policy for configuration and customisation costs, owing to IFRIC's agenda decision in April 2021, the entity will need to change their existing accounting policy.

Unlike new accounting standards with a specific future application date with some lead time, IFRIC agenda decisions have no effective date but should be implemented as soon as possible but allowing an entity sufficient time to do so. The expectation is that this updated accounting policy, if not already adopted, should be implemented by the public sector entity in fiscal forecasts for Budget 2022. This also means that an entity prepares their financial statements for the year ending 30 June 2022 (and beyond) using the updated accounting policy for SaaS arrangements. The Treasury expects the accounting policy change is booked during the preparation of the annual financial statements for the year ending 30 June 2022, which is after the necessary authorities for departments (refer Section 6 of this guidance) are put in place through Budget 2022 processes.

A change in accounting policy, where the impact is material, is applied retrospectively as if the entity had always applied the new policy, except to the extent it is impracticable to do so.⁵ This means comparative financial information should be retrospectively restated to derecognise any previously capitalised costs that should have been expensed or reclassified as a prepayment, where material.

⁵ Required by PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*

Retrospective adjustments and retrospective restatements in respect of a change in SaaS accounting policy are made to the balance of accumulated comprehensive revenue and expense.⁶ Where an entity retrospectively restates its historical financial information, PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the entity to disclose, to the extent possible, for the current period and each prior period presented, the amount of the adjustment for each financial statement line item affected.

The change in the accounting for certain costs associated with SaaS arrangements may result in certain intangible assets reported at 30 June 2021 either being:

- derecognised (written off), and expensed retrospectively, or
- reclassified as prepaid expenses (asset), and subsequently recognised as an operating expense over the expected service period remaining in the SaaS contract.

Derecognising (writing-off) an intangible asset in response to a change in the accounting treatment may also be regarded as bringing forward all the future depreciation expense associated with that asset into an earlier period.

The impact of derecognising intangible assets reported at 30 June 2021 will depend on what reporting period the adjustment relates to (refer table 1 below).

Table 1: Summary of the impact from the retrospective adjustment

	Prior to 2020/21 Fiscal Year	2020/21 Fiscal Year
Accounting treatment in the 2020/21 comparative year, which is presented in the 2021/22 financial statements	Costs that were capitalised up to 1 July 2020 are reported as an opening balance adjustment to accumulated comprehensive revenue and expenses ⁷ in the 2020/21 fiscal year.	Costs that were capitalised during the 2020/21 reporting period will be restated as operating expenditure in 2020/21. Any amortisation / depreciation expense recognised in 2020/21 will no longer exist.

If the retrospective adjustment results in a reclassification of intangible assets to prepayments, this would change the composition of the balance sheet but would not result in an opening balance adjustment to accumulated comprehensive revenue and expenses. However, if there was a material difference between the amortisation phasing of the life of an intangible asset and the release of the prepayment over the expected service period in the SaaS arrangement, there may be some impact on accumulated revenue and expenses.

⁶ Required by PBE IPSAS 1 *Presentation of Financial Statements*, paragraph 124

⁷ While the term ‘comprehensive revenue and expenses’ is used in PBE accounting standards, another common term is ‘accumulated retained earnings’ (part of equity).

5.1 SaaS accounting policy applies to five-year fiscal forecasts in Budget 2022

Entities within the Government reporting entity that submit five-year fiscal forecasts to CFISnet (departments and A and B stream Crown entities and state-owned enterprises) should estimate the impact of the updated accounting policy for SaaS arrangements and include it in their forecast financial statements as part of Budget 2022.

While we expect most entities will book the actual impact of the updated accounting policy during June when preparing their annual financial statements for the year ending 30 June 2022, we request that entities use their best estimate to determine the impact and if material, incorporate it in the forecast financial statements submitted for Budget 2022.

5.2 Materiality and practicability

In deciding whether to apply the updated accounting policy retrospectively and restate comparatives presented in the public sector entity's next set of financial statement, agencies must consider whether the impact of a change in accounting policy for configuration and customisation costs in relation to SaaS arrangements is material. If the impact of the change in accounting policy is not material, the accounting policy does not need to be applied retrospectively and comparatives do not need to be restated.

The term "material" is defined in paragraph 7 of PBE IPSAS 1 *Presentation of Financial Statements* as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements. Materiality depends on the nature and size of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor.

Professional judgement about the materiality of presenting or disclosing information in an entity's financial statements can involve considering both the effect of including information in, and excluding information from, financial reports.

The New Zealand External Reporting Board has issued an Explanatory Guide (EG A7) *Materiality for Public Benefit Entities*⁸ to support agencies in making decisions about whether the impact of an accounting policy is considered material.

In deciding on whether to apply the updated accounting policy retrospectively and restate comparatives presented in the entity's next set of financial statements, agencies must also consider whether it is practicable to quantify the impact of a change in accounting policy and make an adjustment retrospectively. PBE IPSAS 3 states:

29. When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding

⁸ <https://www.xrb.govt.nz/accounting-standards/public-sector/eg-a7/>

adjustment to the opening balance of each affected component of net assets/equity for that period.

30. When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

Public sector entities should determine their judgements on materiality and practicability based on their specific circumstances and their separate financial statements. Agencies should work with their auditors to agree the proposed approach to any accounting policy change in relation to configuration and customisation costs incurred in SaaS arrangements.

As a practical rule of thumb, if capitalised configuration and customisation software costs are less than 2% of total department assets, the item is not likely to be material. This conclusion is supported by the recognition that the difference will be resolved over the period of amortisation of the capitalised costs.

Entities should document their judgements around materiality decisions when considering the impact of the updated SaaS accounting policy on their separate financial statements.

6 Appropriation, baseline and Budget 2022 implications for departments

This section of the guidance does not apply to Crown entities or state-owned enterprises.

This section is specifically for departments who have, or intend to, enter into a SaaS arrangement. The additional guidance is necessary because of the requirements of departments to manage department baselines and appropriations in accordance with the Public Finance Act (PFA) 1989, Cabinet Office circulars, Treasury Instructions and the Treasury's budget guidance.

The change in accounting treatment of SaaS arrangements will have implications for public sector financial management and reporting. These include:

- a. previously expected capital expenditure now being reported as operating expenditure **(Financial reporting implications – refer Sections 4 and 5)**
- b. appropriation changes in Votes to reflect the change in the accounting treatment **(Appropriation implications – refer Section 6.1)**
- c. flow on impacts to departments baselines and Crown funding **(Baseline implications– refer Section 6.2)**, and
- d. the approach for agencies when seeking new funding and how this funding is managed against Budget allowances **(Budget 2022 implications – refer Section 6.3)**.

This section covers the implications in respect of b) to d) above. Refer Sections 4 and 5 for guidance on the financial reporting implications.

Key takeaways for departments:

Appropriation implications

- *An appropriation change in the 2021/22 fiscal year will be needed for the retrospective accounting adjustment as at 30 June 2021 where a previous capitalised intangible asset now needs to be derecognised (written-off). The retrospective accounting adjustment at 30 June 2021 is made up of two components:*
 - *the intangible asset net book value as at 1 July 2020*
 - *other capitalised intangible assets and/or depreciation to be reversed in 2020/21 fiscal year.*
- *In seeking authority for the retrospective adjustment, departments have the option to either:*
 - *establish an ‘other expense’ appropriation for the derecognition of the intangible asset, or*
 - *use an existing output appropriation with a valid scope.*
- *In the situation where the accounting treatment for SaaS arrangements results in a reclassification to a prepayment asset, no further appropriation is necessary as there is no expense in the current year and the authority for capital expenditure had been previously provided.*

Baseline implications

- *Appropriations and Crown funding beyond the 2021/22 will remain unchanged for Budget 2022. However, we will revisit this funding issue when we have more information through the Budget 2022 process and year end reporting.*
- *If SaaS arrangements result in the recognition of a prepayment asset, there will be no depreciation expense, however, an expense (non-cash) will still be recognised to unwind the prepayment asset (similar to the way depreciation allocates the cost of an asset over its life). As this prepayment unwind expense is non-cash, departments should seek funding for the non-cash unwind expense, in the same way departments currently receive depreciation funding.*
- *When we have a better understanding of how material the funding implications from the accounting changes are, we will look to recommend funding options to Ministers. Ideally, we will be aiming for the funding approach to be confirmed and implemented by departments for the 2022 October Baseline Update.*

Budget 2022 implications

- *Departments should ensure that Budget 2022 initiatives best reflect the likely accounting treatment for these arrangements using the updated accounting policy for SaaS arrangements.*
- *The accounting treatment for proposed SaaS arrangements in Budget Initiatives may not be fully known until the time contracts with SaaS providers are negotiated and are in place. The financial recommendations supporting the decision of SaaS arrangements should delegate to Joint Ministers, the ability to shift funding and appropriations between operating and capital (or vice versa), so long as it is fiscally neutral.*

6.1 Appropriation implications

An appropriation change in the 2021/22 fiscal year will be needed for the retrospective accounting adjustment when an intangible asset is required to be derecognised (written-off).

Under section 4 of the Public Finance Act (PFA) 1989, expenses or capital expenditure must not be incurred unless in accordance with an appropriation or other statutory authority. The Public Finance Act excludes remeasurements from the definition of expenses.

An appropriation for the retrospective accounting adjustment will only be required where the change in accounting treatment for SaaS arrangements results in a derecognition (write-off) of an intangible asset. In the situation where the accounting treatment for SaaS arrangements result in a reclassification to a prepayment asset, no further appropriation is necessary as there is no expense in the current year and the authority for capital expenditure had been previously provided.

While the accounting framework requires retrospective restatement of comparatives in financial statements, appropriation adjustments will be reflected in 2021/22 as the decision to adopt the new SaaS accounting policy is a current year decision. The appropriation impacts are summarised in Table 2 below.

Table 2: Appropriation impacts from the retrospective adjustment and 2021/22 transactions

	Prior to 2020/21 Fiscal Year	2020/21 Fiscal Year	2021/22 Fiscal Year
	Comparative Year Presented (Retrospective adjustment)		Current Fiscal Year
Accounting treatment in the 2020/21 comparative year, which is presented in the 2021/22 financial statements	Costs that were capitalised up to 1 July 2020 are reported as an opening balance adjustment to accumulated comprehensive revenue and expenses in the 2020/21 fiscal year.	Costs that were capitalised during the 2020/21 reporting period will be restated as operating expenditure in 2020/21. Any depreciation expense recognised in 2020/21 will no longer exist.	Costs that were capitalised during the 2021/22 reporting period will be restated as operating expenditure in 2021/22. Any amortisation / depreciation expense recognised in 2021/22 will no longer exist.
Appropriation	<p>Authority is required to derecognise the intangible asset (to be captured in the 2021/22 Supplementary Estimates Bill).</p> <p>Derecognising an intangible asset at 30 June 2021 is not a remeasurement under the PFA</p> <p>Departments have the option to either:</p> <ul style="list-style-type: none"> • Establish an 'other expense' appropriation for the derecognition of the intangible asset, or • Use an existing output appropriation where the scope is valid. <p>If using an existing output appropriation in 2021/22, departments will need to determine if an increase in appropriation amount should be sought.</p>		Departments will need to assess the impact of this change on their existing output appropriations in 2021/22 and determine if the upper limits of financial authority are sufficient.

	Prior to 2020/21 Fiscal Year	2020/21 Fiscal Year	2021/22 Fiscal Year
	Comparative Year Presented (Retrospective adjustment)		Current Fiscal Year
Joint Ministers	<p>Both retrospective changes and adjustments in 2021/22 meet the criteria of a technical change under Cabinet Office Circular CO(18)2 <i>Proposals with Financial Implications and Financial Authorities</i>⁹, as they are due to an accounting change with no funding implications. Therefore, Joint Ministers have delegation to approve this change.</p> <p>Approval for these appropriation changes should be sought through the Budget 2022 process.</p>		

The authority sought in Budget 2022 will provide transparency to Parliament of the fiscal impact on the Government's balance sheet on the decision to adopt the new accounting treatment that results in the derecognition of an intangible asset. Also, an accounting policy change does not meet the definition of a re-measurement.¹⁰

The Treasury has engaged with the Office of the Auditor-General and Audit New Zealand on the need for an appropriation, with both supportive of our view.

In seeking this authority, departments have the option to either:

- establish an 'other expense' appropriation for the derecognition of the intangible asset, or
- use an existing output appropriation with a valid scope.

Departments are likely to be treating the cost of existing SaaS intangible assets (amortisation) as an overhead expense allocated to departmental output appropriation(s). As derecognising (writing-off) a SaaS intangible asset may be regarded as bringing forward all the future amortisation/depreciation expense associated with that asset into an earlier period, it follows the expense is still an overhead cost contributing to the same departmental output, regardless of the timing of the SaaS expense in financial reporting.

Alternatively, departments may wish to establish a new 'other expense' appropriation to highlight the one-off nature of this change in SaaS accounting policy.

If electing to use an existing output appropriation in 2021/22, departments will need to determine if an increase in appropriation amount in the current year should be sought.

The appropriation changes from the retrospective accounting adjustment will need to be captured in the 2021/22 Supplementary Estimates Bill, so departments can adopt the change in accounting treatment in the 2021/22 fiscal year with Parliament's authority.

⁹ Refer to DPMC webpage <https://dpmc.govt.nz/publications/co-18-2-proposals-financial-implications-and-financial-authorities>

¹⁰ A change in accounting policy is a decision that is made. Such items are specifically excluded from the definition of remeasurement. Refer to the Treasury's guidance Measuring Remeasurements <https://www.treasury.govt.nz/publications/guide/measuring-remeasurements-treasury-applications-guidance>

Costs incurred in the 2021/22 fiscal year may also need an appropriation change

A change in output appropriation amount for the current year may be required where software configuration and customisation expenses have been incurred, or are expected to be incurred, that result in an upfront operating expense as a result of the new accounting clarification.

We are not expecting changes in appropriation where costs in the current year need to be reclassified as a prepayment asset. Section 24 of the PFA provides a permanent legislative authority for departments to purchase or develop assets. Assets includes prepayment assets in respect of SaaS arrangements. We expect that the previously amortised/depreciated expense will broadly match the unwind of the prepayment, so there is unlikely to be any other appropriation impact. However, if there are any appropriation implications, this should be sought through the Budget 2022 process.

A prepayment recognised for configuration and customisation cost in relation to a SaaS arrangement does not meet the definition of lending under the PFA as the department is not deferring payment to be received; rather the department is paying up front for a service to be provided over time.

6.2 Baseline implications

Departments do not require separate annual appropriations for purchasing departmental assets. Instead, section 24 of the Public Finance Act provides a permanent legislative authority for departments to purchase or develop assets. If working capital or the value recovered from sale of assets was insufficient to purchase a required asset, then a capital injection may be required.

Typically, including amortisation of intangible assets as part of a department's baseline funding allows working capital to build up when output costs are fully funded, thus providing a funding base for replacing intangible assets. With some configuration and customisation costs previously assumed to be capitalised, but now treated as upfront operating expenditure, in principle, ongoing Crown funding will reduce reflecting that there are no longer amortisation expenses for that intangible asset built into the costing of outputs purchased by the Crown.

Departments may have some concerns around this situation as there is high level of uncertainty around the materiality of the accounting change, the impacts on future service potential and challenges for future planning. Given these factors, we are recommending that baselines and Crown funding beyond the 2021/22 remain unchanged for Budget 2022, however, we will revisit this funding issue when we have more information through the Budget 2022 process and year end reporting.

If SaaS arrangements result in the recognition of a prepayment asset, there will be no amortisation/depreciation expense, however, an expense (non-cash) will still be recognised to unwind the prepayment asset (similar to the way depreciation allocates the cost of an asset over its life). At this stage, departments should assume they will receive funding for the non-cash unwind expense, in the same way departments currently receive depreciation funding. This will enable departments to better plan for the replacement of SaaS arrangements, maintain existing services and manage their balance sheet, which is consistent with how other non-financial assets are funded.

When we have a better understanding of how material the funding implications from the accounting changes are, we will look to recommend funding options to Ministers. Ideally, we would be aiming for the funding approach to be confirmed and implemented by departments for the 2022 October Baseline Update.

6.3 Budget 2022 implications

Some departments may be seeking new funding through Budget 2022 that could potentially lead to SaaS arrangements. Budget initiatives need to be managed against Budget operating and capital allowances.

Departments should ensure that Budget 2022 initiatives best reflect the likely accounting treatment for these arrangements using the updated accounting policy for SaaS arrangements. We have previously advised that if any changes are needed to submitted Budget 2022 initiatives, this would need to be done by 25 February 2022 using a best estimate of the components of SaaS arrangement that will be expensed upfront and capitalised. We expect that an upfront expense in SaaS arrangements would be managed against the operating allowance, while any costs that are either capitalised as an intangible asset or recognised as a prepayment asset would be managed against the multi-year capital allowance, with any corresponding operating expense (eg, amortisation or prepayment unwind) managed against the operating allowance.

We appreciate that in most cases, the accounting treatment for proposed SaaS arrangements in Budget Initiatives may not be fully known until the time contracts with SaaS providers are negotiated and are in place. This may mean that funding allocated in Budget 2022 may not correspond to the eventual accounting treatment in respect to what is considered assets and what is consider operating expenses. In this situation, capital to operating (or vice versa) funding and appropriation swaps will be required. We recommend that the financial recommendations supporting a decision around SaaS arrangements delegate to Joint Ministers the ability to shift funding and appropriation between operating and capital (or vice versa), so long as it is fiscally neutral.

Normally for departmental capital investments, funding is sought for capital injections and on-going depreciation expenses associated with the capital investment.

If SaaS arrangements are expected to result in the recognition of a prepayment asset, this will be managed against the multi-year capital allowance. As noted in Section 3.2, there will be no depreciation expense with a prepayment asset, however, an expense (non-cash) will still be recognised to unwind the prepayment asset (similar to the way depreciation allocates the cost of an asset over its life). As this prepayment unwind expense is non-cash, departments will receive funding for the non-cash unwind expense, in the same way departments currently receive depreciation funding. This will enable departments to better plan for the replacement of SaaS arrangements, maintain existing services and manage their balance sheet, which is consistent with how other non-financial assets are funded.

Appendix One: Flow diagrams - accounting for SaaS arrangements

This appendix extracts two flow diagrams (Figures 1 and 3) from the main guidance document for entities' ease of use when assessing SaaS arrangements.

Figure 1: The 2019 IFRIC agenda decision flow diagram (refer Section 2 SaaS Arrangements – service or an asset?)

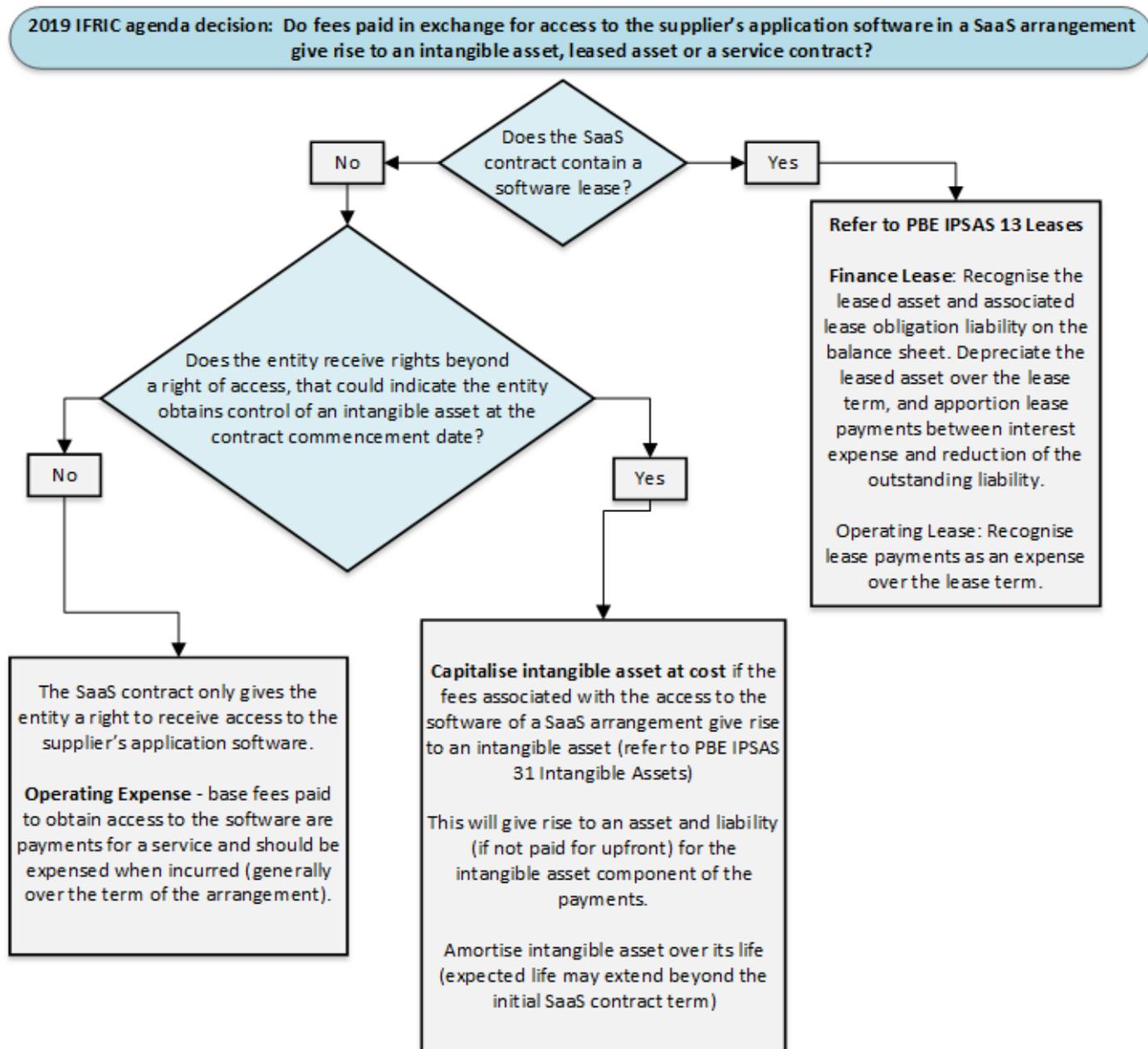
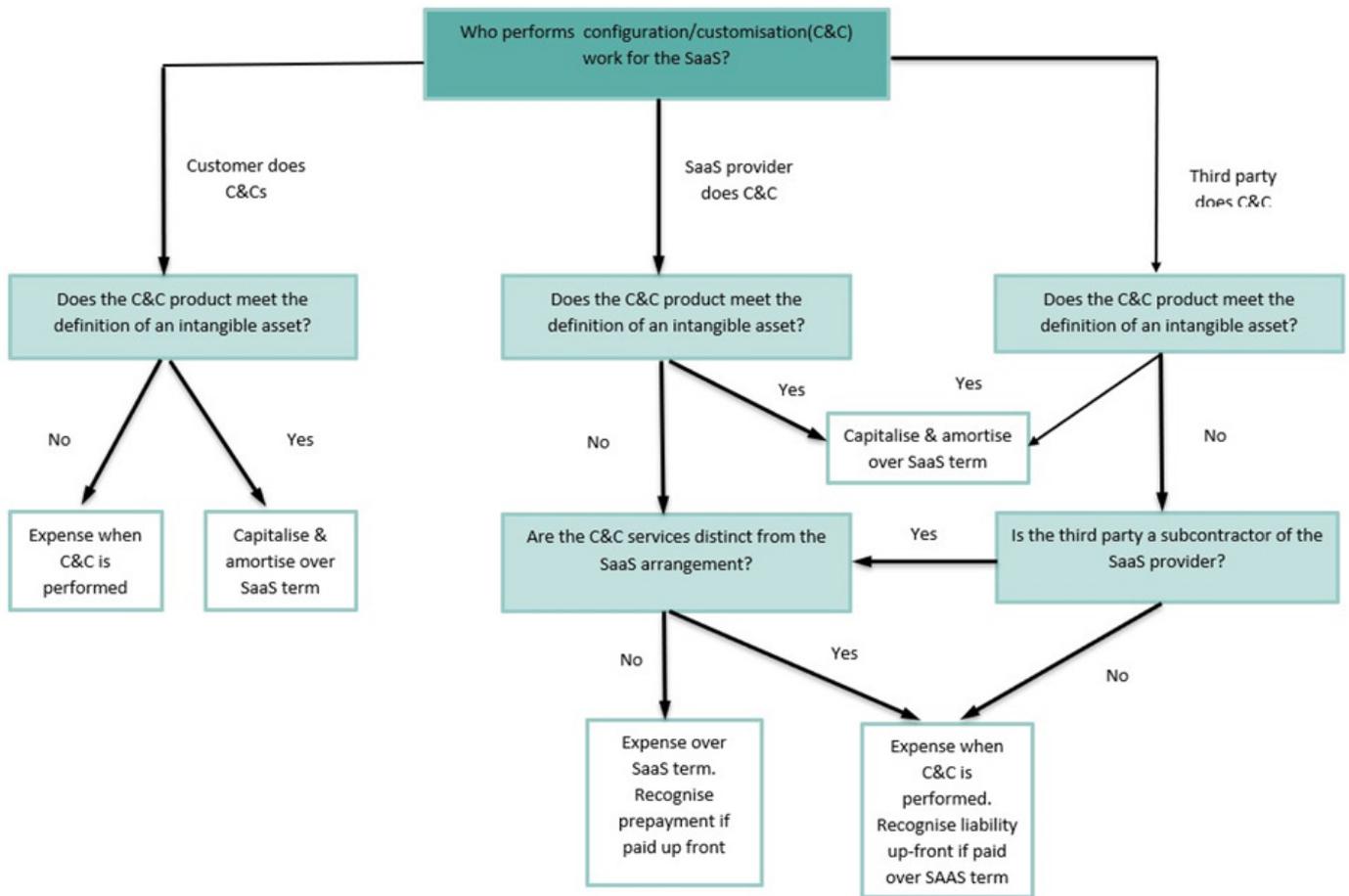


Figure 3: The 2021 IFRIC agenda decision flow (refer Section 3 Configuration and customisation costs – operating expense or intangible asset?)



Appendix Two: IFRIC agenda decisions in relation to SaaS arrangements

This appendix sets out the International Financial Reporting Interpretations Committee (IFRIC) agenda decisions published in 2019 and 2021. These agenda decisions provide authoritative guidance on how a customer accounts for configuration or customisation costs in relation to SaaS arrangements.

This appendix should be read in conjunction with the Treasury's guidance *Accounting for Software as a Service (SaaS) - Accounting guide for public sector entities, including implications on appropriations for departments (February 2022)*.

March 2019 IFRIC agenda decision

Customer's Right to Receive Access to the Supplier's Software Hosted on the Cloud (IAS 38 Intangible Assets)

The Committee received a request about how a customer accounts for a 'Software as a Service' cloud computing arrangement in which the customer contracts to pay a fee in exchange for a right to receive access to the supplier's application software for a specified term. The supplier's software runs on cloud infrastructure managed and controlled by the supplier. The customer accesses the software on an as needed basis over the internet or via a dedicated line. The contract does not convey to the customer any rights over tangible assets.

Does the customer receive a software asset at the contract commencement date or a service over the contract term?

The Committee noted that a customer receives a software asset at the contract commencement date if either (a) the contract contains a software lease, or (b) the customer otherwise obtains control of software at the contract commencement date.

A software lease

IFRS 16 *Leases* defines a lease as 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. Paragraphs 9 and B9 of IFRS 16 explain that a contract conveys the right to use an asset if, throughout the period of use, the customer has both:

- a. the right to obtain substantially all the economic benefits from use of the asset (an identified asset), and
- b. the right to direct the use of that asset.

Paragraphs B9–B31 of IFRS 16 provide application guidance on the definition of a lease. Among other requirements, that application guidance specifies that a customer generally has the right to direct the use of an asset by having decision-making rights to change how and for what purpose the asset is used throughout the period of use. Accordingly, in a contract that contains a lease the supplier has given up those decision-making rights and transferred them to the customer at the lease commencement date.

The Committee observed that a right to receive future access to the supplier's software running on the supplier's cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used - the supplier would have those rights by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run. Accordingly, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the contract does not contain a software lease.

A software intangible asset

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

The Committee observed that, if a contract conveys to the customer only the right to receive access to the supplier's application software over the contract term, the customer does not receive a software intangible asset at the contract commencement date. A right to receive future access to the supplier's software does not, at the contract commencement date, give the customer the power to obtain the future economic benefits flowing from the software itself and to restrict others' access to those benefits.

Consequently, the Committee concluded that a contract that conveys to the customer only the right to receive access to the supplier's application software in the future is a service contract. The customer receives the service - the access to the software - over the contract term. If the customer pays the supplier before it receives the service, that prepayment gives the customer a right to future service and is an asset for the customer.

The Committee concluded that the requirements in IFRS Standards provide an adequate basis for an entity to account for fees paid or payable to receive access to the supplier's application software in Software as a Service arrangements. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

April 2021 IFRIC agenda decision

Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets)

The Committee 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 Committee 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 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 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.

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 Committee 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 Committee 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:
 - 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 Committee 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 Committee decided not to add a standard-setting project to the work plan.