

## ACCOUNTING &amp; FINANCE

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# The accounting treatment of cloud-based software

The ongoing development of the digital world is repeatedly leading to new manifestations of well-known issues that then have to be re-evaluated in accounting. For example, just recently, new forms of software use have become established. While, previously, software was frequently still acquired on physical data carriers and installed on individual end devices, now, cloud-based software solutions are increasing in significance.

## 1. How cloud-based software works

In the case of cloud-based software solutions, the software runs on a central server (the "cloud") that users can usually access via their browsers. In the respective use, a distinction is essentially made between three operating models:

**(1) Infrastructure as a Service (IaaS)** – In the IaaS model, storage space or even a proprietary server is made available to a company by a cloud provider. The company itself installs and operates the software on the server.

**(2) Platform as a Service (PaaS)** – The PaaS model merely comprises the provision of a development platform on which users are then able to develop their proprietary software.

**(3) Software as a Service (SaaS)** – In the case of the SaaS model, the software is made available for use by the software provider on its own servers. The user accesses the software via a browser.

## 2. Accounting treatment of cloud software depends on the operating model

**(1) In the case of IaaS**, the user company is given access by the cloud provider to its infrastructure. A time-based usage fee is incurred and this normally also includes services such as, e.g. maintenance and support. These fees constitute expenses. The software that is installed by the company on the infrastructure constitutes an acquired or an internally generated intangible asset. The presentation of this in the accounts corresponds to the accounting treatment of software that is run on proprietary systems and thus spans familiar territory.

**(2) In the case of PaaS**, the sole difference to the IaaS

case is that no ready-made software is operated on the provider's servers; instead, software is developed there. That is why the presentation in the accounts is based on the same principles as for software development on proprietary systems.

**(3) Cloud software in the case of SaaS** – In accordance with accounting principles, beneficial ownership of an asset is necessary for it to be recognised. In the SaaS model, the software is usually provided for use for a limited period of time only so that, normally, beneficial ownership of the software cannot be acquired. Therefore, the respective amounts will generally have to be recognised as expenses. One-off payments would then have to be spread over the period of the expected useful life by means of a pre-paid expenses item. As the software fees in the SaaS model constitute expenses for time-limited usage these will then have to be added back again when determining trade tax (cf. details of this in the PKF Newsletter 4/2019).

**Please note:** However, caution is required in SaaS cases where, due to the structure of the agreement, the rules for leases would have to be adopted. Accordingly, the intangible asset would have to be recognised in the accounts of the software user (= lessee). A key criterion here is the ratio of the term of the contract to the normal period of the useful life of the asset. A contract term of 54 or more months (90% of the normal period of the useful life of the asset of five years) is usually an indication of beneficial ownership and, thus, of the capitalisation requirement for the lessee. In such a case, the acquisition costs would correspond to the present value of the payments that have to be made to the cloud provider over the term of the contract. The amortisation would be charged over the term of the contract.

## 3. Presentation in the accounts of customisation expenses

Besides the one-off or regular payments for the software itself, frequently, even when cloud software is used, additional costs are incurred for adapting the software to a specific operating environment (customisation). Under certain circumstances, such customisation costs would also then have to be recognised as intan-

gible assets (analogous to fixtures added by a lessee in leased premises) even if the answer to the question

about beneficial ownership of the software had been negative.



## Recommendation

Within the scope of cloud computing projects a number of possibilities will occur with respect to the accounting treatment, particularly in connection with company-specific adjustments. Frequently, these will have to be taken into consideration already when the contract is being formulated. Please do not hesitate to contact your PKF consultant in this respect.

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StBin [German tax consultant] Julia Hellwig

# No obligation to capitalise negligible amounts as pre-paid expenses

Outlays made before the reporting date that constitute an expense for a specific period after that date have to be recorded as pre-paid expenses. Therefore, the capitalisation of such costs is generally mandatory. To-date, in the opinion of the Federal Fiscal Court, the principle of materiality has already made it possible to disregard immaterial items in the course of the recognition and measurement process. The Baden-Wuerttemberg tax court endorsed this principle in its ruling from 2.3.2018 (case reference: 5 K 548/17) with respect to the capitalisation of pre-paid expenses. Accordingly, amounts that fall below the limit defined in Section 6(2) of the German Income Tax Act (low-value assets, currently € 800) do not have to be recorded as pre-paid expenses.

In the above-mentioned case, a sole trader had complained about the increase in his income from commercial operations due to a tax audit. He had recognised negligible expenses that had been paid in advance directly in the income statement instead of capitalising them as pre-paid expenses.

The Baden-Wuerttemberg tax court ruled in favour of the claimant. In the interests of accounting efficiency, recognising expenses on an accrual basis should “not be overdone”. Moreover, the accounting principles of completeness and truthfulness are circumscribed by the principle of materiality, and for a good reason.

StBin [German tax consultant] Sabine Rössler

# Disclosure requirements in the case of dealings involving foreign jurisdictions

Under Sections 138(2) and 138b of the (German) Fiscal Code, German taxpayers are required to notify their tax office of any dealings involving foreign jurisdictions. Such a notification should generally be submitted, together with the tax return, 14 months after the end of the tax period, at the very latest. The following, in particular, have to be reported: the founding, acquisition or disposal of busi-

nesses or holdings abroad. To this end, the tax authority, in the Federal Ministry of Finance circular from 21.5.2019 (case reference: IV B 5 – S 1300/07/10087), has published a new form for fulfilling the notification obligation. The old form should no longer be used. A catalogue with commercial activities of the foreign entity and an explanatory help field that can be searched have also been introduced.