What Buyers Need to Know about Accounting for Outsourcing Implementation Costs

Cost Accounting Considerations in IT Outsourcing

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Executive Summary

Numerous changes in US Generally Accepted Accounting Principles (GAAP) – primarily FASB 146 and EITF 97-13 – and a heightened scrutiny on public financial disclosure have significantly impacted the way that buyers of outsourcing services can and should account for the costs to implement outsourcing initiatives.

The focus of this paper is on the costs that a buyer will incur from the point that it begins to explore its options up to the point that a supplier takes over day-to-day operations in a steady-state mode.These costs may include:

- Exit (or restructure) costs including severance packages, contract termination fees, and costs to consolidate facilities and relocate employees
- Asset impairments resulting from the retirement, abandonment or sale of client assets (primarily IT infrastructure); an asset becomes impaired when its carrying value exceeds its fair market value, and this can also be classified as a restructure cost
- Transition and transformation costs to include, for example, assessment, re-engineering, solution design, and parallel processing
- Software implementation expenses, which can also be classified as transition or transformation costs

Buyers frequently seek advice on how to approach the structuring and recording of these types of expenses.

Primarily, buyers should be aware of the following points:

- As the income statement treatment will differ, it is important to differentiate between restructure costs and transition and transformation costs
- Exit (or restructure) costs include one-time employee termination benefits, contract termination costs, and other costs such as facility consolidation and employee relocation costs
- Outsourcing initiatives, especially IT outsourcing (ITO), frequently will trigger the need to recognize expenses for asset impairment; sale of an asset to a supplier at a price above fair market value (FMV) will not eliminate the need to record an impairment

- It is no longer acceptable for buyers to capitalize transition and transformation costs; although once common practice, it is now specifically prohibited by Emerging Issues Task Force Issue No. 97-13
- Outsourcing implementation costs almost always need to be included in results from continuing operations, but restructure costs can be disclosed on a line-item basis within the income statement
- Although transition and transformation costs are not recorded on a line-item basis in the income statement, these costs will need to be disclosed in the footnotes to the financial statements if they are material in amount
- It is no longer acceptable for buyers to defer the recognition of expenses that are re-billed and/or bundled with future service fees
- If a buyer signs a letter of intent obligating the buyer to reimburse the supplier for expenses related to the outsourcing initiative, the buyer is obligated to accrue these expenses

It should be noted that the guidance contained within this paper is based on Everest Group's advice to its clients. In addition, the information is based on US Generally Accepted Accounting Principles and may not be in exact alignment with International Financial Reporting Standards and International Accounting Standards. However, the definition of restructuring comes from International Accounting Standard No. 37, and there is no reason to believe that there are any material deviations between US GAAP and international standards as it relates to these types of accounting issues.

It is also important to note that the information in this document should be taken as general guidance.The subjects covered are complex, and the referenced literature is of an extremely technical nature. Buyers should always consult with both their internal financial accounting staff and external auditors to determine how they should address the specifics of their situation.

Background Information

The last five to 10 years produced numerous events that impact the way that buyers of outsourcing services account for the costs associated with the initial stages of an outsourcing transformation initiative.These events include:

- The passage and implementation of the Sarbanes-Oxley Act of 2002
- Numerous changes in GAAP
- Increased scrutiny by the investing public on restructuring charges recorded by publicly traded companies

The convergence of these changes significantly altered the landscape for buyers in terms of how they account for costs, beginning with the development of the initial request for proposal (RFP) and continuing through implementation and the achievement of steady-state.

Issues

Although each deal is different, the following list illustrates the types of buyer accounting issues that might arise during the course of an outsourcing project:

1. What accounting literature is considered as the most relevant GAAP?
2. What types of expenses qualify as exit or restructuring costs?
3. Will the initiative result in the impairment or disposal of assets?
4. What other types of expenses will be incurred as a result of the transformation initiatives?
5. What is the appropriate way to account for the costs incurred as a result of implementing a new software system?
6. When should the buyer recognize the associated costs as an expense?
7. What is the appropriate income statement classification for the various costs incurred?
8. Are there any advantages or disadvantages associated with allowing a supplier to initially incur costs and re-bill them at a later date or to bundle them with fees for services in future time periods?
9. What is the potential impact of agreeing to reimburse a supplier for pre-contract transition costs via a letter of intent?

Discussion of the Issues

Issue 1: Accounting literature with relevant GAAP. The following pronouncements are the most authoritative sources applicable to GAAP for the issues outlined above:

- Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (Issued 6/02)
- Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (Issued 8/01)
- Emerging Issues Task Force Issue No. 97-13, Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering with Information Technology Transformation (Issued 11/97)
- AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (Issued 1998)

Issue 2: Expenses that qualify as exit or restructuring costs. It is important from the outset of the project to differentiate between exit or restructure costs on the one hand and transition or transformation costs on the other.There is frequently a pre-disposition to aggressively classify expenses into the exit or restructuring bucket since these types of expenses may be disclosed on a line-item basis in the income statement, lending them to exclusion on a pro-forma basis.

The appropriate accounting for exit or restructure costs incurred as part of an outsourcing initiative is determined by Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities.This document was released in 2002 and nullified Emerging Issues Task Force Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring).

Although restructuring is not specifically defined within US GAAP, International Accounting Standard No. 37, Provisions, Contingent Liabilities and Contingent Assets defines it as "a program that is planned and controlled by management and materially changes either: (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted." This may include but is not limited to costs incurred in selling or otherwise disposing of a part of the business, the consolidation and/or closing of selected sites, or the relocation of operations from one site to another.The costs must be incremental to other costs incurred in the course of normal operations or be associated with a contract that will either be terminated or completed with the enterprise receiving no remaining economic benefit.

FASB 146 does not apply to exit costs incurred for an exit activity that involves an entity newly acquired in a business combination, which are covered by Emerging Issues Task Force Issue No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, or with a disposal activity covered by FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.The exit or restructuring costs that FASB 146 addresses include but are not limited to:

- One-time termination benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement.To qualify as a one-time benefit arrangement under the provisions of FASB 146, the plan of termination must:
  - Have been approved by the appropriate level of management
  - Identify the number of employees to be terminated, including their job classification, locations, and projected termination date
  - Establish the terms of the benefit arrangement with enough detail to allow the impacted employees to determine the type and amount of benefits that they will receive
  - Have been communicated to employees
- Contract termination costs, to include the costs to terminate an operating lease or other contract prior to the end of its term or costs that will continue to be incurred under a contract for its remaining term without the receipt of any economic benefit by the enterprise
- Other associated costs, which include but are not limited to costs to consolidate or close facilities and relocate employees

Issue 3: Impairment or disposal of long-lived assets. Outsourcing initiatives, especially ITO initiatives, frequently lead to the sale, early retirement, or other disposition of longlived assets.The buyer needs to take these costs into account as it contemplates the various costs and benefits associated with the project.

Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets is the primary source of GAAP for determining the appropriate accounting treatment for the disposition of long-lived assets.

Losses from impairment or disposal of long-lived assets can also be classified as restructure costs and are classified in the income statement in the same manner as the exit costs covered by FASB 146 and discussed in the previous section.

FASB 144 contemplates three scenarios related to asset impairments or disposals:

- Long-lived assets to be held and used
- Long-lived assets to be disposed of other than by sale
- Long-lived assets to be disposed of by sale

All three of the above scenarios can occur during the course of an outsourcing initiative.

Impairment, as defined by FASB 144, exists when the carrying amount, or book value, of a long-lived asset exceeds its fair value. Fair value, as defined by FASB 144, is a technical term. It should be noted that a sale of assets by a client to an outsourcing supplier at a price that is above market value will not forestall the need to record impairment.

The provisions of FASB 144 are extremely technical in nature, and buyers should always consult with the appropriate subject matter experts before making a decision regarding the appropriate accounting treatment.

Issue 4: Transition and transformation costs. Most outsourcing initiatives include a multitude of costs that could be categorized as transition and/or transformation costs.The most applicable source of GAAP for these types of expenses is Emerging Issues Task Force Issue No. 97-13, Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering with Information Technology Transformation (Issued 11/97).These types of costs include but are not limited to:

- Preparation and administration of the RFP process
- Current-state assessment
- Process re-engineering
- Workforce re-design
- Other solution design costs
- Recruiting, training, and parallel processing
- Internal-use software acquisition, development, and implementation
- Acquisition of other property and equipment

Costs to acquire or construct property and equipment utilized in an outsourcing initiative should be accounted for in accordance with a buyer's existing policy for fixed assets. (Note: The appropriate accounting for internal-use software will be addressed in the next section.)

Prior to the issuance of EITF Issue No. 97-13 in 1997, it was not unusual for companies to capitalize transition and/or transformation costs. EITF 97-13 changed this, requiring that buyers expense these types of costs when they are incurred.

Buyers often have an inclination to explore the possibility of deferring the recognition of these types of costs to future periods, if possible, so that they may be offset in the financial statements by the operational savings generated by the outsourcing initiative. EITF 97-13 clearly prohibits this practice for any expenditure other than asset purchases or the acquisition and/or development of internal-use software.This is true regardless of whether a buyer incurs the expenses directly or whether a supplier re-bills the expenses. A supplier's bundling these costs with future service fees does not eliminate the requirement for the buyer to recognize the expense when the supplier incurs the cost. EITF 97-13 contains a matrix that summarizes the appropriate treatment of these types of expenses from both a buyer and third-party provider perspective.

Issue 5: Computer software developed or obtained for internal use. AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (Issued 1998), provides detailed guidance on implementing internal-use software as part of an outsourcing initiative.The appendix to EITF Issue No. 97-13 summarizes the detailed guidance contained within this document. Most of the costs associated with the application development stage may be capitalized including:

- Acquisition license fees
- Configuration and integration
- Custom coding
- Installation to hardware
- Testing and parallel processing
- Primary data conversion costs

Most other related costs will need to be expensed as incurred including:

- Implementation planning and evaluation costs
- User training
- Post-implementation operating costs

Issue 6: Timing of expense recognition. The general guidance for recognition of outsourcing-related expenses as discussed in this document is that the cost should be recognized as an expense in the income statement when the buyer incurs the liability. The table on page 9 summarizes specific guidance for the various types of costs.

Type of cost	Timing of expense recognition
Exit or restructuring costs:	
▪ One-time termination benefit	When the buyer communicates the outsourcing plan, unless employees must render service beyond the legal notification period in which case it will be recognized over the period that employees render service
▪ Contract termination costs	When a buyer terminates the contract or when the buyer ceases use of its rights under the contract
▪ Other exit costs	When the buyer incurs measurable liability
Impairment or disposal of long-lived assets	When measurable impairment occurs as defined in FASB 144
Transition or transformation costs	As incurred
Software obtained or developed for internal use	As incurred for costs not capitalized

Issue 7: Income statement classification. All of the costs that have been discussed in this paper should be included in the income statement in results from continuing operations unless they are the result of an exit or disposal activity that involves a discontinued operation as defined in FASB 144. If the activity does involve a discontinued operation as so defined, it should be included within the results of discontinued operations.

Although buyers are required to include most exit or disposal activities (i.e., restructuring charges and asset impairments) in results from continuing operations, FASB 146 does allow an entity to disclose these activities on a line-item basis in the income statement, thus facilitating pro-forma reporting that excludes these costs.

This type of disclosure within the body of the income statement is not allowed for transition or transformation costs, but buyers must disclose them in the footnotes to the financial statements if they are material.

Issue 8: Rebilling and/or bundling of costs by the supplier. There is a long-standing practice within the outsourcing industry of a supplier either rebilling at a later date for transition or transformation costs that it incurred on the buyer's behalf or absorbing these costs and then bundling them with the supplier's ongoing future charges for services. Often in the past, it was also common practice for buyers to defer recognition of these expenses until the supplier billed the expenses. In almost all instances, these practices are no longer acceptable accounting practices.

In theory, it might be possible for a supplier to incur transition or transformation costs that were not visible to the buyer and then bundle these costs into its billing for future services. In this hypothetical situation, the buyer would have no knowledge of the liability and therefore could not record the expense.This is an unlikely scenario in an outsourcing initiative that is facilitated by a third-party advisor. Even if the buyer did not have direct line of sight to the costs that the supplier absorbed, any attempt by the supplier to negotiate material early-termination fees would lead the parties to a discussion of these deferred fees.

Under these circumstances, the only true benefit to the buyer is convenience and, potentially, some float from a financing perspective.

Issue 9: Guaranty of supplier-incurred expenses via a letter of intent. Everest Group counsels its clients not to execute pre-contract letters of intent that obligate the buyer to reimburse the supplier for expenses related to the outsourcing initiative.

Some buyers disregard this advice due to their desire to shorten the implementation timeline. In such situations, the buyer will be obligated to fully accrue these expenses prior to the execution of the contract.

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Our flexible, collaborative approach analyzes the specifics of each sourcing challenge. Throughout the process, we encourage collaboration between buyers and service providers to spark creativity and lay the groundwork for long-term outsourcing success.The result is a solution that recognizes the strengths, weaknesses, and strategic objectives of both parties.

About the Author

Lenny Joiner: Lenny has over 20 years' experience in dealing with outsourcing accounting issues from both the buyer and supplier perspectives. As an industry group controller at EDS, he was responsible for the proper accounting of contract implementation costs from a supplier perspective. As a Senior Consultant with Everest Group, he advises clients regarding the appropriate classification of costs associated with their outsourcing and transformation initiatives. He has a BBA in Accounting and an MBA in Finance from the University of Oklahoma and maintains a Texas CPA license.