Memorandum # 2023-09

TO: Local Government Finance Officials and Their Independent Auditors

FROM: Sharon Edmundson, Deputy Treasurer, State and Local Government Finance Division

SUBJECT: GASB Statement No. 96, *Subscription-Based Information Technology Arrangements*

DATE: April 27, 2023

The Governmental Accounting Standards Board (GASB) issued Statement No. 96, *Subscription-Based Information Technology Arrangements (SBITAs)*, in May of 2020. This statement is effective for fiscal years beginning after June 15, 2022; for most units, this means the fiscal year beginning on July 1, 2022, and ending on June 30, 2023.

Definition and Exceptions

The statement defines a SBITA as "a contract that conveys control of the right to use another party's (a SBITA vendor's) information technology (IT) software, alone or in combination with tangible capital assets (the underlying IT assets), as specified in the contract for a period of time in an exchange or exchange-like transaction." For most units, this is likely to include accounting software that is often subscribed to on a yearly basis but may also include other IT services. As with GASB Statement No. 87, *Leases*, this means that the government is procuring an intangible asset, namely a "right to use" asset, as a resource that can be drawn upon going forward. Any contract that meets this definition must adhere to this statement with a few exceptions:

- Contracts that meet the definition of a lease as defined by GASB Statement No. 87, *Leases,* in which "the software component is insignificant when compared to the cost of the underlying tangible capital asset"
- Governments that provide a "right to use" their own IT software and associated assets to other entities through SBITAs
- Contracts that meet the definition of a public-private or public-public partnership as defined in GASB Statement No. 94, *Public-Private and Public-Public Partnerships and Availability Payment Arrangements*
- Licensing arrangements that provide a perpetual license to governments to use a vendor's software that is subject to GASB Statement No. 51, *Accounting and Financial Reporting for Tangible Assets*

Implementation

The effects of this Statement should be applied retroactively by restating financial statements for all prior years presented, if practicable. The cumulative effect, if any, of applying the Statement should be reported as a restatement of the beginning net position (or fund balance or fund net position, as applicable. Assets and liabilities from SBITA arrangements should be recognized and measured using all relevant information that existed at the start of the earliest fiscal year that is restated. In addition, governments are permitted, but not required to include in the measurement of the subscription asset capitalizable outlays associated with the initial implementation stage and the operation and additional implementation stage incurred prior to the Statement's implementation. In the year of implementation, the notes to the financial statements should discuss the nature of the restatement and its effect, as well as the reason for not restating prior fiscal year statements, if applicable.

The unit will need to review all SBITAs that provide the unit access to a vendor's information technology (IT) software (programs and applications) that are in use at the beginning of the fiscal year to determine those that meet the above definition. This will require coordination between all departments, similar to what occurred with the implementation of GASB Statement No. 87. The Finance and perhaps, IT departments should take a central role in this process. After such SBITAs are identified, they should be recorded as of the first day of the fiscal year during which GASB Statement No. 96 is implemented as described in the preceding paragraph. In addition, any new SBITAs that begin in the fiscal year of implementation should be recorded as provided for in GASB Statement 96 except that there would not be a cumulative effect to report as a restatement.

Determining the Subscription Term / Discount Rate / Subscription Liability / Subscription Asset / Amortization Methods for Subscription Assets and Subscription Liabilities

The subscription term is the period of time that the government has a noncancelable right to use the underlying IT assets plus any of the following periods, if applicable:

1. Periods covered by the government's option to extend the subscription if it is reasonably certain that the option *will be* exercised
2. Periods covered by the government's option to terminate if it is reasonably certain that the option to terminate *will not be* exercised
3. Periods covered by the SBITA vendor's option to extend the subscription if it is reasonably certain that the option *will be* exercised
4. Periods covered by the SBITA vendor's option to terminate if it is reasonably certain that the option to terminate *will not be* exercised

If both parties, unit, and SBITA Vendor, have the option to terminate the SBITA without permission from the other party, a SBITA is cancelable. Likewise, a period where both parties must agree to extend is a cancelable period. A rolling month-to-month SBITA or one that continues into a holdover period where either party can cancel the agreement until a new contract is entered are examples of cancelable periods. When a SBITA has cancelable periods, the maximum term would be the noncancelable period including any notice period. Non-appropriation clauses, if included may be ignored as long as it is reasonably certain that they will not be exercised.

At the commencement of the subscription term, a unit should assess all factors relevant to the likelihood that the unit or the SBITA vendor will exercise any options whether those factors are contract-based, underlying IT asset-based, market-based, or government specific. The assessment often will require the consideration of a combination of interrelated factors. Examples of factors to consider include, but are not limited to, the following:

- A significant economic incentive, such as contractual terms and conditions for the optional periods that are favorable compared with current market rates
- A potential change in technological development that significantly affects the technology used by the underlying IT assets
- A potential significant change in the unit's demand for the SBITA vendor's IT assets
- A significant economic disincentive, such as costs to terminate the SBITA and sign a new SBITA (for example, negotiation costs, costs of identifying another suitable underlying IT asset or another suitable SBITA vendor, implementation costs, or a substantial cancellation penalty)
- The history of exercising options to extend or terminate

- The extent to which the underlying IT assets in the SBITA are essential to the provision of government services.

Normally, once a unit determines the initial subscription term it will not change. A unit should, however, reassess the subscription term only if one or more of the following occur:

1. The unit/SBITA vendor elects *to* exercise an option even though it was previously determined that it was reasonably certain that the unit/SBITA vendor *would not* exercise that option.
2. The unit/SBITA vendor elects *not to* exercise an option even though it was previously determined that it was reasonably certain that the unit/SBITA *vendor* would exercise that option.
3. An event occurs that the SBITA contract requires an extension or termination of the SBITA.

The subscription term commences when the initial implementation stage is completed (i.e., the time when the government has obtained control of the right to use the underlying IT assets), which is when the subscription asset is placed into service. At that time, a unit should recognize a subscription liability and an intangible right-to-use capital asset (i.e., the subscription asset) unless the agreement is a short-term SBITA. A SBITA with a maximum term of 12 months, including any option to extend (regardless of the probability it will be exercised) is a short-term SBITA and should be expensed.

The subscription liability should initially be measured at the present value of the subscription payments expected to be made during the subscription and should include the following:

1. fixed payments
2. variable payment that depends on an index or a rate (such as the Consumer Price Index), measured as of the commencement date
3. variable payments that are fixed in substance
4. payments for penalties for terminating a SBITA If the subscription term reflects the unit's organization plans to exercise an option to terminate or a fiscal funding or cancellation clause
5. SBITA incentives receivable from vendor
6. any other payments to the SBITA vendor associated with the contract that is reasonably certain of being required on an assessment of all relative factors.

Variable payments based on future performance of the unit, usage of the underlying IT assets, or number of user seats, should <u>not</u> be included in the initial subscription liability. Instead, those variable payments should be recognized as expenses in the period in which the obligation is incurred. However, any component of those variable payments that are fixed in substance should be included in the measurement of the subscription liability.

The future subscription payments should be discounted using the interest rate the SBITA vendor charges the unit, which may be the rate implicit in the SBITA. If the unit cannot readily determine the interest rate the unit should use its estimated incremental borrowing rate. GASB No. 96 permits but does not require units to apply paragraphs 173-187 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989, FASB, and AICPA Pronouncements* as a means of determining the interest rate implicit in the SBITA. Units may want to have an upfront discussion with their independent auditors about the determination of the discount rate.

In subsequent reporting periods, a unit should calculate the amortization of the discount on the liability and report that amount as an outflow of resources (for example, interest expense).

The subscription asset should be initially measured as the sum of the following (less any incentive payments received from the SBITA vendor at the commencement of the subscription term):

1. the initial measurement of the subscription liability
2. contract payments made to the SBITA vendor at the commencement of the subscription term
3. capitalizable initial implementation costs.

Payments made related to the contract or implementation costs prior to the subscription term should be reported as a prepaid asset. This prepayment would be reclassified as an addition to the initial measurement of the subscription asset at the start of the subscription term. Further, the subscription asset should be reduced by SBITA vendor incentives that provide payments to, or on behalf of units at or before the commencement of the subscription term.

A subscription asset should be amortized in a systematic and rational manner over the shorter of the subscription term or the useful life of the underlying IT assets. The amortization of the subscription asset should be reported as an outflow of resources (for example, amortization expense), which may be combined with depreciation expense related to other capital assets for financial reporting purposes. Amortization should begin on the commencement of the subscription term. A subscription asset should generally be adjusted by the same amount as the corresponding subscription liability when that liability is remeasured.

The subscription liability should be remeasured if one or more of the following changes have occurred on or before subsequent financial reporting dates (based on the most recent SBITA before the changes) and the changes are expected to significantly affect the amount of the previous measurement of the subscription liability individually or in the aggregate if:

1. There is a change in the subscription term
2. There is a change in the estimated amounts for subscription payments already included in the measurement of the subscription liability
3. There is a change in the interest rate the SBITA vendor charges the unit, and that rate was used as the initial discount rate
4. A contingency upon which some or all variable payments that will be made over the remaining term are based, is resolved so those payments now meet the earlier described criteria for measuring the liability (e.g., an event occurs that causes payments previously contingent on the performance or use of the underlying IT assets to become fixed for the remainder of the subscription term)
5. A previously unexercised existing option is exercised (e.g., an option to extend or terminate the SBITA)

If a subscription liability is remeasured for any of the above reasons, other factors should also be reviewed to determine if they experienced a change that is expected to significantly affect the amount of the previous liability measurement. If so, those items should also be included in the remeasurement. These items include:

1. any change in an index or a rate used to determine variable payments (no remeasurement is required solely for a change in that index or a rate)
2. the discount rate when there is also a change in the subscription term (no reassessment is necessary solely for a change in a unit's incremental borrowing rate).

When a subscription liability is remeasured the related subscription asset generally should be adjusted by the same amount. However, if that change reduces the carrying value of the subscription asset to zero, any remaining amount should be reported in the resource flows statement (for example, as a gain).

Accounting under GASB Statement No. 96

The accounting for SBITA's is similar to that of GASB Statement 87 accounting by the lessee. LGC staff has created an implementation worksheet similar to the previously released GASB 87 templates that may be useful in implementing this statement. Consider the following example:

> The City of Dogwood has entered into a subscription-based IT arrangement for new accounting software that began on July 1 of 2022. The term of the subscription is 5 years and will require an annual payment of $10,000 due on July 1st of each year. The discount rate is 3%. During the initial implementation stage, The City incurred $2,500 in data conversion costs, which will be capitalized as part of the subscription asset (the costs are necessary to place the subscription asset into service).

	SBITA Questionnaire		
1	SBITA Description (include description of asset)		Accounting Software
2	What is your fiscal year end?		6/30/2023
3	Beginning Subscription Date		7/1/2022
4	Was the arrangement in place prior to the first year of GASB 96 implementation?		N
5	Prior fiscal year end for SBITA restatement under GASB 96		6/30/2022
6	Ending Arrangement Date		6/30/2027
7	First Subscription Payment Due Date on/after	7/1/2022	7/1/2022
8	Last Subscription Payment Due Date		7/1/2026
9	What is the subscription payment frequency (monthly, quarterly, annually)?		Annually
10	Are there any subscription prepayments to be applied to future months?		N
11	NA		
12	Are there capitalizable implementaion costs associated with the subscription asset?		Y
13	How much are the implementation costs?		2,500.00
14	Was an incentive received at or before the commencement of the SBITA?		N
15	NA		
16	What is the annual discount rate for the SBITA at	7/1/2022	3.0%

Under the **current financial resources measurement focus and the modified accrual basis of accounting** (the GAAP basis for the governmental funds and the budgetary basis for all budgeted funds in NC including Enterprise Funds), the government will initially need to recognize an expenditure and other financing source (OFS). These amounts should be measured similar to the subscription liability. The subscription asset should equal the OFS plus any capitalizable initial implementation costs (e.g., data conversion costs).

This information should also be reported in the budget to actual comparison reported in the financial statements. Because of the need for this entry, a unit may require a budget amendment or a reconciling item explaining the differences between the reported GAAP governmental fund expenditures and the budgeted fund expenditures in the financial statements.

7/31/2022	Capital Outlay		49,670.98	
		Other Financing Source		47,170.98
		Cash		2,500.00
	To record inception of SBITA and data conversion costs			

As with GASB Statement 87, subsequent subscription payments will be recognized (and budgeted for) like debt service payments made on long-term debt. Interest would be 0 for the initial payment made at the start of the term because no interest has accrued.

7/31/2022	Debt Service Expenditure - Principal		10,000.00	
	Debt Service Expenditure - Interest		-	
		Cash		10,000.00
	Record subscription payment			

In order to recognize this subscription in the Government-wide, Proprietary and Fiduciary Fund statements (any statements based on the **economic resources measurement focus and the accrual basis of accounting** at year end), **adjusting entries** will need to be made that will essentially “undo” and “redo” the previous entries to recognize a subscription asset and liability.

Subscription Asset		49,670.98	
Other Financing Source		47,170.98	
	Subscription Liability		47,170.98
	Capital Outlay		49,670.98
To record inception of SBITA and data conversion costs			

As part of the conversion process for the Government-wide and other statements reported on the economic resources measurement focus and the accrual basis of accounting, the subscription payments will need to be reclassified and the subscription asset amortized. Generally speaking, at the beginning of the subscription term, the government will recognize a subscription asset (the “right to use” asset, including capitalizable implementation costs) and a corresponding subscription liability including certain costs associated with the implementation of the contract. The subscription liability should be recognized as the PV of the total subscription payments and the data conversion costs (capitalizable implementation costs) will be shown as an outflow of cash.

If applicable, the liability would include fixed and variable payments, any penalties expected to be realized for terminating the SBITA (if reasonably certain to be realized when calculating the term), any incentives offered by the vendor and any payments to the vendor associated with the contract (such as implementation costs). The present value will be discounted using the implicit rate from the contract; if this is not easily determinable, an estimated incremental borrowing rate can be used. This example uses an incremental borrowing rate of 3% and the straight-line method to amortize the asset over 5 years.

Subscription Liability		10,000.00	
Interest Expense		-	
	Debt Service Expenditure - Principal		10,000.00
	Debt Service Expenditure - Interest		-
Record subscription payment			
Amortization Expense Subscription Asset		9,934.20	
	Accumulated amortization - subscription asset		9,934.20
Record subscription asset amortization			

Interest expense should be accrued and recognized at year end and can be calculated by multiplying the outstanding principal balance remaining on the contract by the interest rate by the days since the last interest payment divided by 365 days.

Interest Expense		1,112.07	
	Accrued Interest		1,112.07
Accrue unpaid interest at year-end - entry reverses in subsequent month.			

Outlays Other Than Subscription Payments

Outlays other than subscription payments should be categorized into three stages. Training costs should be expensed as incurred regardless of the stage:

1. The preliminary project stage would include costs incurred prior to negotiating a contract such as evaluating vendor options or technological needs. These should be expensed as incurred.
2. The initial implementation stage would include costs associated with putting the subscription asset into service such as installation or testing of the asset. These should be included in the initial calculation of the subscription asset and amortized throughout the subscription term (data migration costs in our example).
3. The operation and additional implementation stage would include costs related to subsequent activities such as maintenance. These should generally be expensed as incurred.

Notes to Financial Statements

Units are not required to provide disclosures for individual SBITA contracts. Instead, for purposes of disclosures, information may be grouped (i.e., aggregated). Each year that a unit reports SBITAs the notes to financial statements should disclose the following information:

1. A general description of its SBITAs, including the basis, terms (e.g., length of agreement, options for renewal and termination, discount rate, etc.)
2. The total amount of subscription assets and related accumulated amortization, separately from other capital assets
3. Commitments before the commencement of the subscription term
4. Principal and interest requirements to maturity for the subscription liability, presented separately for each of the five subsequent fiscal years and, at a minimum, in five-year increments for the years thereafter.

When a SBITA includes variable payments, the unit should disclose:

1. Terms and conditions on which variable payments not included in the measurement of the subscription liability are determined
2. The amount of outflows of resources recognized in the reporting period for variable payments not previously included in the measurement of the subscription liability.

Further, the amount of outflows of resources recognized in the reporting period for other payments (such as termination penalties, not previously included in the subscription liability) should be disclosed.

Generally, impairments of subscription assets occur because of a change in the manner or duration of use of the underlying IT assets. If a unit reports an impairment loss for a SBITA it should disclose the components of the loss (the impairment loss and any related change in the subscription liability).

Please note that the above disclosures about a unit's SBITAs do not apply to short-term SBITAs (i.e., those that have a maximum term of one year or less).

While certain debt disclosures (e.g., debt service requirements to maturity) apply to subscription liabilities, GASB Statement No. 96 specifies that such liabilities are not considered debt that is subject to the disclosure requirements in Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*.

Outlays Other Than Subscription Payments, including Implementation Costs/Stages of implementation

In addition to the subscription payments to for the right to use the underlying IT assets, a unit may also have to make additional payments. These payments should be grouped into three stages. These stages and the treatment of the outlays for amounts other than subscription payments are as follows:

1. Preliminary Project Stage. Outlays are expensed as incurred
2. Initial Implementation Stage (this stage is completed when the subscription asset is placed into service). Outlays are generally capitalized (if no subscription asset is reported amounts should be expensed as incurred)
3. Operation and Additional Implementation Stage. Outlays are generally expensed as incurred.

Outlays that occur after the subscription asset has been placed in service (outlays in the operation and additional implementation stage) are potentially capitalizable. Such outlays should be capitalized as part of the existing subscription asset if they result in either:

- An increase in the functionality of the subscription asset (i.e., allows the unit to perform tasks that it could not previously perform) or
- An increase in the efficiency of the subscription asset (i.e., an increase in the level of service provided by the subscription asset without the ability to perform additional tasks).

Any additional outlays that are a result of SBITA modifications, should follow the accounting described below. Training costs should be expensed as incurred, regardless of the stage in which they are incurred.

Treatment of data conversion outlays will depend on the circumstances. Such outlays should be considered an activity of the initial implementation stage (i.e., capitalizable) only to the extent that it is determined that they are necessary to place the subscription asset into service (that is, in condition for use). Otherwise, such outlays are an activity of the operation and additional implementation stage and are expensed as incurred. This includes outlays associated with a SBITA already in operation that relate to converting a unit's legacy data on an old server to the vendor's cloud storage.

There are several things to consider if the government enters into a SBITA with multiple components. If the contract has a subscription and non-subscription component, the government should account for each as a separate contract if possible. If such a contract does not include pricing for the individual components (or they appear unreasonable), the unit should use professional judgment to determine its best estimate. However, if it is not practical to estimate the amounts for the components, the government can account for these components as a single SBITA. In this case, accounting decisions (such as the subscription term) should be based on the primary subscription component.

The provisions of a SBITA contract may be amended to change its provisions while it is in effect. Examples of such amendments include changing the contract price of the arrangement, lengthening, or shortening the subscription term, adding, or removing underlying IT assets, and changing the index or rate upon which variable payments depend (as mentioned earlier an exercise of an existing option would require a remeasurement). An amendment should be considered a SBITA modification unless the unit's right to use the underlying IT assets decreases. In that case, the amendment should be considered a partial or full SBITA termination.

In certain cases, an amendment would not be reported as a modification. Instead, a unit should account for such changes as a separate SBITA (that is, separate from the most recent SBITA contract before the modification). The reporting of a separate SBITA is required if *both* of the following conditions are present:

1. The change gives the unit an additional subscription asset by adding access to more underlying IT assets that were not included in the original SBITA and
2. The increase in subscription payments for the additional IT assets does not appear to be unreasonable based on (1) the terms of the amended SBITA and (2) professional judgment that maximizes the use of observable information (for example, using readily available standalone prices)

Unless required to be reported as a separate SBITA a unit should account for the contract modification by remeasuring the subscription liability. The subscription asset should be adjusted by the difference between the remeasured liability and the liability immediately before the SBITA modification. If the change reduces the carrying value of the subscription asset to zero, any remaining amount should be reported in the resource flows statement (for example, as a gain).

However, a unit should report an amendment resulting in a decrease in the government's right to use the underlying IT assets (e.g., the subscription term is shortened, or the underlying IT assets are reduced) as a partial or full SBITA termination. A unit generally should account for the partial or full SBITA termination by reducing the carrying values of the subscription asset and subscription liability and recognizing a gain or loss for the difference.

Other Things to Consider

The statement may not apply to SBITAs that are determined to be immaterial. Units will need to use professional judgement and review their arrangements and documentation thoroughly to determine materiality. Materiality will vary by unit. The subscription asset and liability should both be considered. If either or both are material, then the statement will apply.

The foundation of GASB Statement No. 96, *Subscription-Based Information Technology Arrangements,* was based on the guidance for GASB Statement No. 87, *Leases;* as such, it is recommended that you review the guidance on this as well. For more information on GASB Statement No. 87, please see memos #2021-05, #2021-09, and #2022-09 on our website here. If you have further questions on this memorandum or any of the guidance provided by the Division, please contact the staff of the State and Local Government Finance Division at 919-814-4300.