EU COVID-19 ‘Quick Fix’ for software asset deductions in response to COVID-19 impacts

Time to review IFRS capitalization policies?

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Executive summary

The pressure placed by COVID-19 on European banks is well documented. To help ease that pressure, the European Union (EU) enacted emergency amendments to the EU Capital Requirements Regulation (CRR) known as the ‘CRR Quick Fix’ which include an end to the requirement to deduct the full value of software intangible assets from Common Equity Tier 1 (CET1) capital.

In summary:

- EU banks and other financial institutions are no longer required to deduct the full value of software assets from CET1 capital
- Deduction for software assets is now based on prudential accumulated amortization, calculated with reference to amounts included on a bank’s balance sheet for accounting purposes

In an early example of post-Brexit rule variation, the UK’s Prudential Regulatory Authority (PRA) decided against implementing equivalent rules for UK banks. This regulatory change has brought the capitalization policy for IT spend by EU banks and their subsidiaries applying IFRS Standards under increased scrutiny. Banks are taking this opportunity to ensure that their accounting policies applicable to intangible assets developed in-house or acquired in merger and acquisition activity comply with the requirements of IAS 38, the IFRS Standard on intangible assets.

At the same time, audit firms are also paying closer attention to IAS 38 compliance to ensure the increased attraction of capitalization has not resulted in inappropriate recognition of intangible assets.

This publication summarizes the regulatory rules and accounting requirements to help bring clarity to the capitalization framework. However, there is no substitute for an informed conversation with a specialist to help businesses navigate the rules with a view to arrive at a robust position compliant with IFRS Standards that enables entities to maximize the advantages of the new rules and to be ready to best respond and be ‘audit ready.’

Software assets, COVID-19 and bank capital relief

In response to the circumstances following the COVID-19 pandemic, the European Commission introduced emergency amendments to the EU CRR known as the 'CRR Quick Fix.' These are designed to help mitigate the capital impact of an economic downturn on banks and encourage them to continue lending to the real economy. The amendments were enacted in June 2020.

Since the rule change became effective during 2020, EU banks are no longer required to deduct the full value of software assets from CET1 capital. Specifically, CRR Article 36(1)(b) exempts eligible software assets from the deduction requirement for intangible assets from CET1 capital. Instead, the amount to be deducted in relation to software assets is now determined based on prudential accumulated amortization, calculated with reference to amounts included on a bank's balance sheet for accounting purposes.

This rule change carries two critical potential benefits for banks. In the short-term, it frees up regulatory capital, enhancing the banks' ability to lend during the downturn. Long term, it should facilitate investment in digitalization and technology.

The global effect

The relief from deduction that arises in the EU leads to interesting questions for banks that are subsidiaries of EU banks or vice versa. For example, in the UK, the new EU financial services law ceased to apply at the end of the post-Brexit transition period, on 31 December 2020. The PRA published a statement highlighting its intent to consult on the prudential treatment of software assets and confirming its intention to maintain a position whereby all software assets are fully deducted from CET1 capital.

As such, UK banks cannot take advantage of the Quick Fix which is also likely to be the case for firms incorporated in other jurisdictions. On face value, where such firms are subsidiaries of EU banks, the consolidated CRR position of the EU parent may appear to benefit from the capitalization policies of the non-EU subsidiary. However, in reality it is likely that other provisions of CRR may limit or eliminate that apparent benefit in the consolidated position to take account of that capital being trapped within the subsidiary. In the opposite direction, relief in EU located subsidiary banks may not flow through to the consolidated position of their non-EU parent. Detailed regulatory due diligence would need to be undertaken to understand the cross-border position.

Potential benefits for EU banks

Prior to the rule change, the CRR required intangible assets, net of their associated deferred tax liabilities, to be deducted in full from CET1 capital. Accordingly, heavy investment in software technology (obtained through acquisition or in-house development) was detrimental on regulatory capital and reduced the banks' capacity to inject more liquidity in markets. As such, it created a disincentive for banks to invest in IT systems and processes.

The rule change carries a number of potentially significant benefits for EU banks.

Firstly, in the context of the current and expected future strains on banks' balance sheets, it could free up a significant amount of capital, helping banks to provide credit to the real economy. The numbers are big—a quick look at annual reports of banks reveal intangible assets totaling billions related to software assets—though actual regulatory deduction will depend on several factors including how close the accounting amortization period is to the regulatory amortization period.

Secondly, there are important implications for banks' long-term competitiveness. The COVID-19 pandemic has accelerated the uptake of digitally-enabled working practices and increased customers' reliance on digital banking services. At the same time, the pandemic has brought some banks' legacy IT infrastructure under considerable strain in certain jurisdictions where the administration of some government support schemes has been a significant challenge for some banks. Banks that invest in technology may be better placed to serve the evolving expectations of their employees and customers.

Furthermore, the COVID-19 pandemic and the consequent lockdowns are likely to test the viability of some challenger firms which offer digital banking services. This may create opportunities for banks to merge with, or acquire, firms with valuable proprietary software technology. As a result of the rule change, this will become a less expensive endeavor for banks.

The focus turns to the accounting for software

As noted above, the rule change exempts eligible software assets from the full deduction requirement for intangible assets from CET1 capital. Instead, for software assets that are recognized as intangible assets for accounting purposes, the deduction from CET1 will be determined based on the difference between prudential accumulated amortization and the carrying amount of the assets under applicable accounting framework.

The European Banking Authority (EBA) noted that close scrutiny by regulators, supervisors, and external auditors would be warranted, as a change in the regulatory treatment would be likely to influence the accounting treatment of software assets and other related aspects of accounting. In addition, the EBA has stated that it is its intention to closely monitor the evolution of assets going forward, including the link between the prudential treatment and the need for EU institutions to make necessary investments in IT developments in areas like cyber risk or digitalization.

Hence, the recent rule change has brought the accounting treatment of software, IT technology, and intangible assets into focus.

For EU banks applying IFRS Standards, software assets are generally recognized as intangible assets. For banks or institutions not applying IFRS Standards, the applicable national Generally Accepted Accounting Principles (GAAP) may follow principles similar to IFRS Standards, however, some differences may exist resulting in different amounts recognized on the balance sheet.

IAS 38 establishes general principles for the recognition and measurement of intangible assets and the treatment of subsequent expenditure on recognized intangible assets. It considers in detail the situations that give rise to intangible assets, including separate acquisition, acquisition as part of a business combination, and internal development.

Software is typically recognized as an intangible asset as a result of acquisition, as a separate asset, through M&A activity (i.e. as part of a business combination) or in-house development (referred to in IAS 38 as 'internally generated').

Intangible assets that meet the recognition criteria in IAS 38 are initially measured at cost and amortized on a systematic basis over their useful lives (with limited exception).

Off the shelf software

The accounting for software assets purchased 'off the shelf[1]' is generally straightforward. As 'separately acquired[2]' assets, generally these meet the criteria to be recognized on balance sheets at the price paid.

Acquired through M&A activity

If an intangible asset is acquired through M&A activity as part of a business combination, it is recognized at its fair value at the acquisition date.

That fair value represents a portion of the M&A acquisition price determined as the price that would be received to sell the asset in an orderly market transaction. This holds true irrespective of whether the asset was previously recognized by the acquiree. These requirements in IFRS Standards are wide ranging and encompass any in-process research and development project of the target—provided the recognition criteria are met.

The EU Quick Fix capital changes provide a significant incentive to M&A activity. As explained more fully below, the target bank may have generated in-house software that failed the more stringent recognition criteria of IAS 38 for such assets. However, the requirements applicable to intangible assets acquired as part of a business combination may result in recognition of the intangible asset. Indeed, an acquirer is required to capitalize eligible software assets of the acquiree even though the acquiree was unable to capitalize in its own books. Broadly, what was off balance sheet comes on balance sheet. As such, banks seeking to merge or acquire firms with internally developed and proprietary software technology may end up recognizing a valuable intangible asset which had not been recognized by the acquired firm previously.

Therefore, it is expected that the capital rule change will spark increased M&A interest and greater attention (and scrutiny) of valuations placed upon software assets acquired as part of business combinations. This is particularly the case given that IFRS Standards require that any excess of the price paid for the business combination that is not allocated to the identifiable net assets acquired, including intangible assets, is attributed to goodwill. Goodwill, for regulatory purposes, continues to be deducted in full from CET1 capital.

In-house developed software assets

Known by IFRS Standards as 'internally generated intangible assets,' this is the most challenging class of software assets to capitalize. This is because IAS 38 requires capitalization of the costs incurred in developing a software asset if and only if it is probable that expected future benefits attributable to the asset will flow to the entity and its cost can be determined reliably.

IAS 38 distinguishes two phases in the development of intangible assets—the research phase and the development phase with costs being capitalized only during the latter if certain criteria are met. In particular, a bank will need to demonstrate technical feasibility of completing the software project so that it will be available for use, how it will generate sufficient future economic benefits, the availability of sufficient relevant resource to complete development, and an ability to reliably measure the expenditure. Expect auditors to place close attention to the complete list of criteria.

IAS 38 does not provide any guidance in respect of the requirement to identify *when* technical feasibility is established. When the asset is the product of software development activities, an appropriate point may be when the bank has completed all the planning, design, and testing activities that are necessary to establish that an asset can be produced to meet its design specifications, including functions, features, and technical performance requirements.

The requirement that an intangible asset acquired separately, such as a software asset, should be initially recognized at its 'cost' applies equally to in-house developed software. Cost includes all costs incurred from the date on which all of the recognition criteria are met. If costs have been expensed prior to the recognition criteria being met, they may not be reinstated upon satisfaction of the criteria.

Determining when an internally generated intangible asset arising from development activities meets the recognition criteria can involve a significant level of judgment.

The capitalization of costs incurred on internally generated intangible assets is mandatory under IFRS Standards if the recognition criteria are met. Certain national GAAPs may permit a choice whether to capitalize development costs or expense them as incurred. Banks reporting under such GAAPs that have previously chosen not to recognize intangible assets on their balance sheet may want to reconsider this accounting policy choice, if permitted, in light of the change to the regulatory treatment.

The global effect

Under IFRS Standards, banking groups are required to apply consistent accounting policies throughout the corporate group for the purposes of their consolidated financial statements. For practicality, it is not uncommon for banking groups to require their subsidiaries to apply these same accounting policies in their own the financial statements. As such, any refinements to IAS 38 accounting prescribed by an EU parent is likely to be relevant to their non-EU subsidiaries even though capital relief may not be available locally. Indeed, it may be material non-EU subsidiaries that inform the accounting policies of the group.

Cloud computing—another angle

Banks and other institutions are commonly entering into cloud computing arrangements in relation to software (among other IT items).

A typical cloud computing arrangement can see a bank enter into a 'software as a service' arrangement in which it pays 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 bank accesses the software on an as needed basis over the internet or via a dedicated line. Generally, these contracts do not convey to the bank any rights over tangible assets.

Depending on facts and circumstances, the arrangement may result in the bank receiving either:

- a software asset at the contract commencement date (because either the contract contains a software lease or the entity otherwise obtains control of software at contract commencement date); or
- a service.

To assess whether it has obtained a *software lease*, the bank must analyze the definition of a lease provided in IFRS 16 *Leases*. If a lease is identified, this may result in the bank recognizing on its balance sheet an asset presenting the bank's right to use the software and a liability to pay for it. The market continues to evolve and each contract must be analyzed according to its own merits. However, typically the ability to receive access to the software does not in itself give the bank the decision-making rights about how and for what purpose the software is used. It is the supplier that exercises 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 the contract conveys only the right to receive access to the supplier's application software, the contract does not contain a software lease. In other situations, a lease may be present. In such situations, the bank may account for the contract either as a lease applying IFRS 16 or as an intangible asset applying IAS 38.

The regulatory position for such assets is not straightforward. Generally, right-of-use assets arising from IFRS 16 accounting are risk weighted at 100% provided that the underlying asset is tangible in accordance with accounting standards. Software assets are intangible and as such would not have qualified for this risk weighting treatment. The Quick Fix does not change their accounting classification. As such, the question arises as to which piece of legislation prevails—the Quick Fix risk weighting because the assets are software, or the specific CRR rules that apply to assets arising from leases that may suggest deductions continue due to their intangible nature. Detailed regulatory advice will need to be obtained.

To assess whether it has obtained a *software intangible asset,* the bank would apply the requirements in IAS 38 discussed above. In particular, a software intangible asset is acquired only if the bank has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. As such, if a contract conveys to the bank only the right to receive access to the supplier's application software over the contract term, the bank has not obtained software intangible asset at the contract commencement date.

If the contract conveys to the bank only the right to receive access to the supplier's application software in the future, then it is a *service contract*. The bank receives the service (i.e. the access to the software) over the contract term. If it pays the supplier before it receives the service, that prepayment gives the bank a right to future service and is an asset for the bank.

In all cloud computing arrangements, careful consideration will need to be given to the specific facts and circumstance and terms of the arrangement in order to determine the appropriate accounting and the consequences on CET1 capital.

How can Deloitte help?

Deloitte has substantial technical and practical experience to help you assess your software asset capitalization policy. Deloitte Assurance professionals can advise you on instilling robust policies that consider all necessary angles and that your internal IFRS Standards compliance documentation is of high quality.

In the light of the new regulations, auditors are expected to pay close attention to capitalization policies. Deloitte Assurance professionals can assist you in preparing and gaining confidence in your numbers so you are 'audit ready'.

Deloitte can provide the full range of assurance services from policy health checks to detailed challenges against the IFRS Standards. Please reach out to your usual contact.

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