GAAPTUS

Embedded Software Finance Leases Diagnostic

A framework for pinpointing cloud software subscription fees that should be capitalized and not charged to OpEx



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1. Why This Matters



This diagnostic helps finance leaders quickly assess whether cloud software subscriptions include embedded software licenses that US GAAP (ASC 350-40, *Internal Use Software*) requires to be accounted for in a manner similar to finance leases (informally referred to here as "software finance leases").

For companies that track EBITDA as a key performance metric, this assessment helps ensure EBITDA is not unintentionally understated. Companies sometimes charge the entire subscription fee ratably to operating expenses (OpEx), directly reducing reported EBITDA, even though GAAP may require a portion of the subscription (often roughly 25%–85%, where applicable) to be accounted for in a manner similar to a finance lease, meaning that portion should not impact EBITDA.

Embedded software finance leases are more common than many companies realize. A familiar example is the Microsoft 365 subscription, which often includes software finance leases related to Office applications (Word, Excel, PowerPoint, Outlook) and Windows. In addition, IT departments often manage subscriptions more material than Microsoft 365 that warrant review.

2. The Big Picture

This diagnostic is just one of many components of the Capitalization Completeness Framework™ used by GAAPTUS Consulting to help companies quickly identify capitalization policy gaps. These are situations where costs are currently flowing through OpEx but GAAP requires capitalization, and peer companies are, in fact, capitalizing those costs. We use the Completeness Framework to perform a structured, rapid review across risk areas.

In our experience, software finance leases typically represent about 20%–40% of costs flowing into OpEx through capitalization policy gaps. For example:

- **Example 1**

  If this diagnostic identifies $100,000 per year to move out of OpEx due to software finance leases, the aggregate exposure flowing through capitalization gaps could be $250,000–$500,000 per year.

- **Example 2**

  If it identifies $1 million per year, the aggregate exposure could be $2.5 million–$5 million per year.

Diagnostic Finds		Total Exposure
$100K per year	→	**$250K–$500K** per year
$1M per year	→	**$2.5M–$5M** per year

3. The Accounting Issue

Historically, downloadable software was often sold via perpetual licenses with a one-time upfront payment that was capitalized. Over time, vendors shifted toward subscription bundles that combine downloadable software, hosted components, and ongoing services.

ASC 350-40 uses the term “software license” to describe certain downloadable software included in a subscription contract that meets specific criteria and must be accounted for separately from the hosting and service components, in a manner akin to a finance lease:

A software asset is recognized, often classified within PP&E or intangible assets, and expensed through depreciation and amortization.

A related liability for future committed payments is recognized, unless the subscription is prepaid in full at inception.

4. The Diagnostic

Below are the three core steps companies should take to assess impact.

4.1 - Step 1: Size the potential impact

Estimate the potential range of financed software impact by applying 25% (lower end) and 85% (upper end) to your annual subscription expense.

This step intentionally assumes every subscription includes qualifying software finance leases that are currently being charged entirely to OpEx.

- If the resulting exposure is inconsequential to your financial results, you may conclude no further work is required.
- If consequential, proceed to Step 2.



4.2 - Step 2: Identify subscriptions that contain software "finance leases"

A software finance "lease" exists only when all of the following criteria in ASC 350-40-15-4A & B are met:

1	The company has the right to take possession of the software (a "download right").
2	No significant incremental cost would be incurred if the software were downloaded.
3	It is feasible to self-host the software or host it with a third party unrelated to the vendor.
4	The software can be used separately without significant diminution in utility or value.

We also add a fifth criterion that reflects common practice (although it is not explicitly required by ASC 350-40):

5	The committed subscription term is at least 12 months.

See Appendix 1 for a practical discussion of these criteria.

4.3 - Step 3: Quantify impact and assemble audit support

For subscriptions that meet the above criteria, allocate the contract consideration due over the committed term, using a relative standalone selling price methodology, between:

- The software "finance lease" (CapEx component)
- The non-capitalizable OpEx components



This allocation often requires significant judgment and supportable estimates. In our experience, the amount allocated to the CapEx components is typically between 25% to 85%.

Once quantified, assemble audit-ready documentation that clearly supports:

- Application of ASC 350-40 criteria
- Resulting impact on financial statements
- Basis for allocation between CapE and OpEx components

5. Example Public Company Disclosure – Choice Hotels

For the avoidance of doubt, Choice Hotels is not a GAAPTUS client. It is referenced here because its public filings include clear disclosure of how it capitalized software licenses associated with cloud computing arrangements. While Choice Hotels classifies these capitalized software licenses within intangible assets, many companies classify such assets within the PP&E "software" category.

The more important takeaway is that the underlying economics are properly reflected: a financed software asset is recognized, and the related cost is excluded from OpEx so EBITDA is measured appropriately.

Except from 2024 10-K

7. Intangible Assets

The components of the Company's intangible assets were the following:

(in thousands)	As of December 31, 2024 Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Franchise Rights [1]	$ 278,956	$ 67,620	$ 211,336
Franchise Agreement Acquisition Costs [2]	548,544	128,932	419,612
Trademarks & Other [3]	12,444	6,414	6,030
Capitalized SaaS Licenses [4]	6,392	6,071	321
Total amortizing intangible assets	846,336	209,037	637,299
Trademarks (non-amortizing) [5]	246,714	—	246,714
Total intangible assets	$ 1,093,050	$ 209,037	$ 884,013

(in thousands)	As of December 31, 2023 Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Franchise Rights[1]	$ 354,735	$ 123,845	$ 230,890
Franchise Agreement Acquisition Costs[2]	424,695	98,103	326,592
Trademarks & Other[3]	19,876	13,721	6,155
Capitalized SaaS Licenses[4]	17,397	16,673	724
Total amortizing intangible assets	816,703	252,342	564,361
Trademarks (non-amortizing)[5]	246,714	—	246,714
Total intangible assets	$ 1,063,417	$ 252,342	$ 811,075

Footnote 4 reads "Represents software licenses that have been capitalized under a SaaS agreement, which are generally amortized on a straight-line basis over an average period of 3 years"

APPENDIX 1 – Applying criteria for identifying a software license

A software finance "lease" exists only when all of the following criteria are met:

1. Right to take possession of the software (download right).
2. No significant incremental cost would be incurred if downloaded.
3. It is feasible to self-host the software or host it with a third party.
4. The software can be used separately without significant diminution in utility or value.
5. Committed term is at least 12 months (policy convention).

When these criteria are met, cloud subscription fees over the committed term are allocated between the software finance lease (CapEx) and OpEx components using a relative standalone selling price basis. This often involves significant judgment and coordination between accounting and IT.

Below is a practical example using Microsoft 365, since most finance teams are familiar with this product family. Many Microsoft 365 bundles include software that is already downloaded, software that is downloadable but not yet downloaded, and ongoing services (hosting, maintenance, OneDrive, etc.).

Criterion 1. Right to take possession of the software

Downloaded software

- If the software is already downloaded, Criterion 1 is already met.
- Your IT department will know which software is currently installed across the organization on both laptops, desktops and servers.
- *For M365, downloaded software often includes Office apps (Word, Excel, PowerPoint, Outlook) and Windows.*

Downloadable-but-not-downloaded

- Contracts may explicitly state whether the company has the right to download.
- *Depending on the M365 version, rights may include downloadable software such as Exchange and SharePoint.*

Criterion 2. No significant incremental cost would be incurred if downloaded

"Incremental cost" includes both (a) incremental contractual fees to exercise the download right and (b) incremental cost of hosting the software with a party other than the vendor (self-hosting or third-party hosting). In practice, the sum of these should not be "significant," often interpreted as not exceeding approximately 10% of committed contract fees.

Downloaded software

- If the software is already downloaded and in use, Criterion 2 is generally met.

Downloadable-but-not-downloaded

- Contracts often specify whether an incremental download fee applies — frequently, there is none. For hosting costs apart from the vendor:
  - Organizations with substantial existing "fixed cost" hosting infrastructure often meet this criterion because they can leverage current capacity.
  - Organizations whose existing hosting is largely "variable cost" must carefully evaluate significance of incremental hosting expense.

Criterion 3. Feasibility of self-hosting or third-party hosting with party unrelated to vendor

Downloaded software

- If the software is already downloaded and in active use, Criterion 3 is usually met.

Downloadable-but-not-downloaded

- Accounting teams should confer with IT on the technical feasibility of hosting the software elsewhere. In practice, this criterion is often met for enterprise software.

Criterion 4. Ability to use software separately without significant diminution in utility or value

This criterion is met only if **both** of the following are true:

A. Performance does not deteriorate significantly if hosted elsewhere, including consideration of whether the company would lose rights to updates or upgrades if it downloads the software.

B. The software provides meaningful functionality on a standalone basis, separate from the cloud-based components of the bundle.

Downloaded software

- Software that is already downloaded and in use generally meets factor (a). A practical test for factor (b) is to consider whether the downloaded software still provides meaningful functionality if the live connection to the vendor's servers is disabled.
- *For example, Office apps (Word, Excel, etc.) in an M365 subscription clearly meet both factors. By contrast, the Facebook app downloaded to a phone is technically "downloaded software," but without an internet connection back to Facebook's servers, it does not provide meaningful separate functionality, and therefore fails factor (b).*

Downloadable-but-not-downloaded

- Contracts often do not restrict access to significant benefits solely because the software is downloaded. Accounting and IT teams should jointly evaluate potential performance diminution and standalone functionality if, hypothetically, the software is downloaded.

Criterion 5. Committed term of at least 12 months

The assessment for this criterion is the same for downloaded and downloadable software.

This is an accounting policy convention. A commonly applied practice is that if the noncancellable committed term is at least 12 months (including periods with substantive termination penalties), the subscription is eligible for capitalization of qualifying software components.

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