



Project	Revenue Recognition
Topic	Accounting for costs in contracts with customers

Introduction and purpose

1. At a joint Board meeting in November 2009, the Boards considered whether to develop any cost guidance for contracts with customers. The IASB decided to not develop any cost guidance and instead to require an entity to account for costs in accordance with other standards as applicable. The FASB asked the staff to further analyze the cost guidance in U.S. GAAP.
2. In February, the FASB further considered cost guidance in U.S. GAAP and decided:
 - (a) to specify that an entity should expense all costs of obtaining a contract with a customer (e.g. selling, advertising, and marketing costs), and
 - (b) to develop guidance on when an entity should recognize an asset for costs incurred to fulfil a contract with a customer.
3. This paper seeks the FASB's view on the guidance needed in U.S. GAAP for the recognition of an asset from the costs of fulfilling a contract with a customer.
4. This paper also seeks the IASB's view on the implications of the FASB's decision on IFRSs.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff recommendations

5. The staff recommends that the FASB develop guidance for costs associated with contracts with customers. In accordance with that guidance, an entity should:
 - (a) recognize as expenses (i) the costs of obtaining a contract, (ii) the costs relating to satisfied performance obligations, and (iii) the costs of abnormal waste, spoilage, and inefficiencies in fulfilling a contract.
 - (b) recognize as an asset the direct costs of fulfilling a contract if those costs (i) generate or enhance a resource that the entity will use to satisfy performance obligations in the contract and (ii) are probable of recovery.
 - (c) amortize the asset as the goods or services to which the asset relates are transferred to the customer.
 - (d) test the asset for impairment in accordance with existing guidance on the impairment of long-lived assets (ASC Section 360-10-35).
6. The staff recommends that the IASB:
 - (a) specify (in the revenue standard) the same guidance as the FASB for costs associated with contracts with customers except that an entity would test the asset for impairment in accordance with IAS 36 *Impairment of Assets*.
 - (b) withdraw from IAS 2 the guidance on inventories of a service provider.

Structure of paper

7. This paper is organized as follows:
 - (a) The FASB's decision to address costs of fulfilling a contract (paragraphs 8–14)
 - (b) The contract asset and costs of obtaining a contract (paragraphs 15–21)
 - (c) The FASB's alternatives to address costs of fulfilling a contract

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- (i) Codify parts of IFRSs (paragraphs 22–39)
- (ii) Develop new guidance (paragraphs 40–53)
- (d) The implications for IFRSs (paragraphs 54–64)

The FASB’s decision to address costs of fulfilling a contract

8. At the February 3, 2010 FASB meeting, the FASB considered existing U.S. GAAP on accounting for the costs to fulfil a contract with a customer.
9. In a contract for the transfer of a tangible product, an entity clearly would apply existing inventory guidance. However, in other contracts, the FASB acknowledged the lack of clear guidance in U.S. GAAP on how an entity should account for the costs to set up and fulfil the contract.
10. Absent clear guidance, entities often capitalize costs of fulfilling a contract by analogizing to Paragraph 310-20-25-2 (on the deferral of direct loan origination costs) and to Paragraph 605-20-25-4 (on the deferral of the incremental direct costs of acquiring a separately-priced warranty or maintenance product). The SEC has endorsed that practice in ASC 605-10-S99 (SAB 104).
11. The proposed revenue recognition model could, if no cost guidance is developed, result in even less cost guidance for U.S. GAAP than exists today because it would supersede Section 605-20-25. In that case, the staff thinks that practice would rely more heavily on the analogy to the deferral of direct loan origination costs. The FASB expressed concerns with practice relying too heavily on that analogy.
12. The FASB also expressed concerns about the potential effects of the proposed model superseding Subtopic 605-35 *Construction-Type and Production-Type Contracts* and, in particular, its guidance on the deferral of some costs that are incurred before revenue is recognized (but the costs are probable of recovery under a specific contract or anticipated contract).

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13. Because of those concerns, the FASB decided to develop guidance on when an entity should capitalize contract fulfillment costs. By developing cost capitalization guidance, the FASB noted that their intention is not simply to normalize profit margins throughout a contract. Rather, the intention is to focus on the recognition of assets associated with contracts with customers.
14. The FASB's decision to address the accounting for contract fulfillment costs and focus on the recognition of assets is supported by many constituents. For example, one respondent to the Discussion Paper noted:

We believe that standard setting, whether in this project or another project, must address the accounting for costs if the Boards proceed with the proposed approach. Consider, for example, the costs incurred by an entity in situations in which the entity intends to deliver a final product (development of a new technology, proof of concept, audit report, etc) at the end of the arrangement term. In these cases, it is necessary for the entity to incur the costs to generate the final product, and the entity is willing to incur those costs with the intention that it will realize a margin upon delivery of the final product. That is, the costs are associated with the development of an *asset* to the entity: the entity controls the work product (workpapers, the developed know-how, etc); the entity expects to derive a future economic benefit (consideration from the customer); and, the work product is the result of past events. A similar issue occurs in revenue arrangements that legally permit the entity to "recover" certain costs from the customer. We believe that entities may provide misleading financial information about their assets and liabilities if this issue is not addressed. (Financial Executives International/CCR)

The contract asset and costs of obtaining a contract

15. The staff thinks that the FASB's decision to address the costs of *fulfilling* a contract does not affect the Boards' decision that an entity should expense the selling and other costs of *obtaining* a contract. The costs of fulfilling a contract relate to assets separate from the contract (e.g. inventory, PP&E, and intangibles). The costs of obtaining a contract primarily relate to the contract asset.

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16. A contract asset is the asset arising from the combination of the remaining rights and performance obligations in a contract. In concept, a contract asset can arise in one of two ways:
 - (a) as a result of obtaining a contract (i.e. when the explicit measurement of the remaining rights exceeds the measurement of the remaining obligations), or
 - (b) as a result of an entity satisfying its performance obligations in a contract before the customer pays for the goods or services underlying those performance obligations.
17. If a contract asset is recognized as a result of obtaining a contract, its measurement at contract inception generally would vary in accordance with the level of effort and resources required by entities to obtain that type of contract. That is, the value of the asset at contract inception would be relatively greater in industries in which obtaining a contract with a customer is costly. The costs of obtaining a contract include the costs of selling, advertising, marketing, solicitation, bid and proposal, and negotiations.
18. The staff acknowledges that in the insurance contracts project, the Boards are considering whether it is appropriate for the initial measurement of an insurance contract to reflect the costs of obtaining a contract (e.g. selling commissions). If the Boards decide to recognize a contract asset (or reduce a contract liability) at contract inception in the insurance contracts project, the Boards will need to justify that decision and reconcile it to the decisions in the revenue recognition project.
19. In the revenue recognition project, the Boards have extensively considered whether an entity should recognize a contract asset as a result of obtaining a contract. The Boards decided to prohibit it. Therefore, in the proposed revenue recognition model an entity recognizes a contract asset only as a result of satisfying a performance obligation in the contract. An entity recognizes all the costs of obtaining a contract as expenses when incurred even if those costs are direct and incremental (e.g. incremental costs of securing an investment management contract).

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20. One possible way to justify the potential difference between the projects is to acknowledge that the insurance contracts project focuses on the (recognition and) explicit measurement of an insurance contract. Measurement of the remaining obligations under an insurance contract even if calibrated to the transaction price could exclude any cash flows that have already been incurred (e.g. selling commissions or other costs of obtaining the contract). Hence, the entity could recognize a contract asset (or reduce a contract liability) as a consequence of measuring the contract.
21. In contrast, the revenue project does not focus on explicitly measuring a contract with a customer. Rather, the proposed revenue model requires an entity to allocate the transaction price to the performance obligations. That allocated transaction price approach precludes the recognition of a contract asset unless a performance obligation is satisfied.

The FASB's alternatives to address costs of fulfilling a contract

22. The staff thinks the FASB has two main alternatives to address the lack of guidance in U.S. GAAP on accounting for the costs of fulfilling a contract:
 - (a) codify parts of IFRSs, or
 - (b) develop new guidance.

Alternative 1: Codify parts of IFRSs

23. In November 2009, the IASB decided to not develop any cost guidance as part of the revenue recognition project. One reason for that decision was that IASB members thought that existing IFRSs (e.g. IAS 2 *Inventory*, IAS 16 *Property, Plant and Equipment*, and IAS 38 *Intangible Assets*) adequately address how entities in various industries should account for the costs to fulfil a contract.
24. The staff thinks that existing IFRS guidance does provide a broader framework on the recognition of contract costs than U.S. GAAP. One reason for that is that the

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IASB's conceptual framework is authoritative in IFRSs when existing standards do not specifically address a particular issue.

25. Another reason is that existing IFRS guidance on inventory and intangible assets can be applied more broadly than the corresponding guidance in U.S. GAAP. Hence, one alternative for the FASB to fill the void in U.S. GAAP is to codify parts of IFRS guidance on inventory and intangible assets.

Inventory

26. In U.S. GAAP, inventory includes only tangible items. Hence, an entity clearly would apply existing inventory guidance when a contract with a customer involves the sale of a tangible product.
27. However, if a contract does not involve the sale of a tangible product, it is not clear whether and how an entity would apply existing inventory guidance in U.S. GAAP. In contrast, IAS 2 clearly states that inventories include the costs of a service for which revenue has not yet been recognized.
28. Paragraph 19 of IAS 2 describes those costs:

To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads.
29. The staff understands that this guidance was added to IAS 2 largely because of concerns that an entity might be required to recognise costs as an expense in advance of revenue recognition, even though those costs relate to services to be provided to the customer in the future.
30. Because the gap in U.S. GAAP relates primarily to those situations (i.e. costs of services in advance of revenue recognition), it might be helpful for the FASB to clarify (as IAS 2 does) that "inventory" includes the costs of a service for which revenue has not yet been recognized.

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Intangible assets

31. Various intangible assets can arise because of a contract with a customer. For example, an entity might develop expertise and know-how in a contract that benefits the contract (or other contracts) in the future.
32. In general, entities do not recognize intangible assets because of the challenges of identifying (and measuring) something that lacks physical substance. However, intangible assets are recognized when they are acquired separately or with other assets (e.g. in a business combination).
33. Both U.S. GAAP and IFRSs specify when an entity should recognize an intangible asset that is internally developed. However, the guidance in IFRSs arguably is broader than the guidance in U.S. GAAP.
34. In U.S. GAAP, ASC Topic 350 *Intangibles—Goodwill and Other* provides guidance on the recognition of intangible assets for software (both for internal use and to be sold) and website development. ASC Topic 340 *Other Assets and Deferred Costs* provides guidance on the recognition of assets for development stage entities and for some design and development costs of long-term supply contracts.
35. In IFRSs, IAS 38 paragraph 57 specifies the following criteria for the recognition of an intangible asset for development activities:
 - An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:
 - (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
 - (b) its intention to complete the intangible asset and use or sell it.
 - (c) its ability to use or sell the intangible asset.
 - (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

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- (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

36. IAS 38 paragraph 59 states that “development activities” include:

- (a) the design, construction and testing of pre-production or pre-use prototypes and models;
- (b) the design of tools, jigs, moulds and dies involving new technology;
- (c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- (d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

37. The guidance in IAS 38 applies more broadly than the specific guidance in U.S. GAAP. Hence, codifying parts of IAS 38 might provide guidance that does not exist at present in U.S. GAAP.

Staff analysis

38. Codifying parts of IFRSs into U.S. GAAP might fill some of the gap in U.S. GAAP on accounting for the costs of fulfilling a contract. Moreover, it would result in greater consistency between U.S. GAAP and IFRSs.

39. However, the staff notes the following disadvantages of codifying parts of IFRSs:

- (a) it is not clear whether the limited guidance in IAS 2 on inventory of services providers would adequately address the lack of guidance in U.S. GAAP on accounting for costs to fulfil a contract. The staff understands (from discussions with constituents since November) that the guidance in IAS 2 is difficult to apply in practice and is susceptible to misinterpretation. Entities using that guidance might stretch the notion of inventory and capitalize any cost related to the contract.

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- (b) there is a risk of unintended consequences by codifying IAS 38 on a piecemeal basis when that guidance was developed in a context broader than contracts with customers.
- (c) the FASB would need to modify the definition of inventory to include intangible items. Some people think it is counterintuitive for inventory to include intangible items.
- (d) further analysis of existing inventory guidance in U.S. GAAP and IFRSs could reveal additional issues that could significantly delay the revenue recognition project.

Alternative 2: Develop new guidance

40. Another alternative for the FASB would be to develop new guidance on accounting for the costs to fulfil a contract with a customer. That guidance would apply only to contracts with customers and could address contract costs more directly by specifying the costs that should be expensed when incurred and the costs that are eligible for recognition as an asset.

Costs that should be expensed when incurred

41. The staff thinks the Boards have been clear about which costs associated with contracts with customers should be recognized as expenses when incurred. Those costs include:
- (a) the costs of obtaining a contract (e.g. selling, marketing, advertising, soliciting, bid and proposal, negotiations),
 - (b) costs that relate to satisfied performance obligations in the contract (i.e. costs relating to goods and services already transferred), and
 - (c) costs that relate to abnormal waste, spoilage, or other inefficiencies in the entity's performance.

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Costs that give rise to an asset

42. In defining the costs that give rise to an asset, the staff thinks the FASB should use the definition of costs for purposes of testing whether a performance obligation is onerous. For the onerous test, the Boards defined costs as the “direct costs”—i.e. all costs that relate directly to the contract or that were incurred only because the entity entered into the contract.
43. Costs that relate directly to a contract (i.e. “direct costs”) include:
 - (a) direct labor,
 - (b) direct materials,
 - (c) an allocation of costs that relate directly to the contract or contract activities (e.g. costs of contract management and depreciation of equipment used on the contract),
 - (d) costs that are directly chargeable to the customer under the contract, and
 - (e) other costs that were incurred only because the entity entered into the contract (e.g. subcontractor costs).
44. The staff thinks that an entity should first evaluate whether the costs incurred in fulfilling a contract are in the scope of other standards. If so, the entity should account for them in accordance with those standards. If not, the entity should recognize an asset, separately from the contract asset, only if the costs:
 - (a) relate directly to a contract,
 - (b) generate or enhance a resource that the entity will use to satisfy performance obligations in a contract, and
 - (c) are probable of recovery under a contract.
45. If an entity cannot distinguish (a) the costs that generate or enhance a resource that the entity will use to satisfy performance obligations in a contract from (b) costs that relate to satisfied performance obligations in the contract, an entity should recognize those costs as expenses when incurred.

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46. The staff thinks that any costs that meet the criteria in paragraph 44 would give rise to an asset in accordance with the FASB's definition of assets. Moreover, the staff thinks those criteria are consistent with existing guidance such as ASC Section 605-35-25 which would be superseded by the proposed revenue recognition model (similar guidance exists in IAS 11 paragraph 21):

Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained shall not be included in contract costs or inventory before the receipt of the contract. However, such costs otherwise may be deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.

Amortization of the asset

47. An asset arising from the direct costs of fulfilling a contract would be amortized (and recognized as a cost of sales) as the goods or services to which the asset relates are transferred to the customer.

Impairment

48. An entity could test the asset for impairment in accordance with one of various asset impairment models in U.S. GAAP including:
- (a) capitalized software (ASC Paragraph 985-20-35-4),
 - (b) inventory (ASC Paragraph 330-10-35-1), and
 - (c) long-lived assets (ASC Paragraph 360-10-35-17).
49. If the FASB develops guidance for the recognition of an asset, the staff recommends using the asset impairment model for long-lived assets for the following reasons:
- (a) it is the most recent asset impairment model issued by the FASB, and
 - (b) the nature of the asset being tested for impairment is more similar to long-lived assets held for use than to inventory. Inventory is an asset transferred to a customer whereas an asset recognized in accordance with paragraph 44

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is not transferred but is used to create the goods or services to be transferred,

- (c) it is more generally applicable than the specific guidance on capitalized software.

50. In accordance with ASC Paragraph 360-10-35-17:

An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (see paragraph 360-10-35-33) or under development (see paragraph 360-10-35-34). An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

Staff analysis and recommendation

51. The staff thinks that developing new guidance provides the following advantages over codifying parts of IFRSs:

- (a) it would be a clearer, more direct approach of addressing the need for guidance on contract fulfillment costs. The FASB has acknowledged the need for guidance on how to account for costs incurred in a contract with a customer. Existing guidance on inventory, PP&E, and intangibles applies to contexts broader than contracts with customers. Developing new guidance would address the issue directly in the context for which the guidance is intended.
- (b) it would avoid the potential complexity, and unintended consequences, of codifying parts of IFRSs on a piecemeal basis.

52. For the reasons noted above, the staff recommends that the FASB specify cost guidance similar to what is in paragraphs 41–48.

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53. The examples in Appendix A illustrate how the staff's recommendation would be applied.

Question 1 Cost guidance for U.S. GAAP

The staff recommends that the FASB develop guidance for costs associated with contracts with customers. In accordance with that guidance, an entity should:

- (a) recognize as expenses (i) the costs of obtaining a contract, (ii) the costs relating to satisfied performance obligations, and (iii) the costs of abnormal waste, spoilage, and inefficiencies in fulfilling a contract.
- (b) recognize as an asset the direct costs of fulfilling a contract if those costs (i) generate or enhance a resource that the entity will use to satisfy performance obligations in the contract and (ii) are probable of recovery.
- (c) amortize the asset as the goods or services to which the asset relates are transferred to the customer.
- (d) test the asset for impairment in accordance with existing guidance on the impairment of long-lived assets (ASC Section 360-10-35).

Does the FASB agree?

Implications for IFRSs

54. In accordance with the IASB's tentative decision in November 2009, an entity that incurs costs in fulfilling a contract would evaluate whether those costs have resulted in:
- (a) an item of inventory,
 - (b) an intangible asset, or
 - (c) an item of property plant or equipment
- qualifying for recognition in accordance with IAS 2, IAS 38 or IAS 16, respectively.

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55. In some contracts, it will be clear which standard an entity should apply. For instance, consider a consulting entity that is working on a report for a client but the client does not use or benefit from that work until the report is delivered—i.e. the performance obligation is satisfied in a future period. The entity would capitalize the time costs of the consultants as part of the cost of an inventory asset in accordance with IAS 2.
56. In other contracts, an entity would be required to use judgment in determining which standard to apply. For example, consider an entity that has obtained a contract to provide payroll processing services for a client. Before the entity can process the client's monthly payroll, the entity incurs costs to design, modify and test its systems and processes. The entity might consider whether those costs have resulted in a development phase intangible asset that would qualify for recognition in accordance with IAS 38. Alternatively, the entity might conclude that those setup costs are "costs of the service", i.e. inventories of a service provider in accordance with IAS 2.
57. The IASB could affirm its decision in November 2009 and require entities to continue using judgment in determining which standard to apply.
58. However, as noted in paragraph 39(a), the staff has learned of practice issues with IAS 2. Moreover, because the cost guidance in IAS 11 will be withdrawn, entities would be required to rely more heavily on the guidance in IAS 2.
59. Hence, the staff thinks the IASB can improve existing IFRSs by doing one of two things:
 - (a) specify, in the revenue standard, the same guidance proposed for U.S. GAAP, or
 - (b) withdraw the guidance for service provider inventories in IAS 2 and instead, require entities to apply IAS 38 to such assets.

Specify the same guidance proposed for U.S. GAAP

60. The IASB could specify the same guidance proposed in paragraphs 41–48. As a consequence:
- (a) more costs would be accounted for similarly under U.S. GAAP and IFRSs (i.e. mainly costs other than those resulting in an item of tangible inventory or PP&E).
 - (b) an entity would have clear, direct guidance on contract fulfillment costs.
 - (c) the IASB would create new guidance for a specific type of asset—an asset arising from direct costs that generate or enhance a resource that the entity will use to satisfy performance obligations in a contract.
 - (d) in some cases, the new guidance will be redundant with the guidance in IAS 38 (e.g. the costs of developing a new process or system).

Withdraw from IAS 2 the guidance on inventories of a service provider

61. Given the issues noted in paragraph 39(a) with the guidance for inventories of a service provider, the IASB could withdraw that guidance and instead require entities to apply IAS 38. As a consequence:
- (a) an entity would not have to distinguish between intangible assets to be accounted for in accordance with IAS 2 and those in accordance with IAS 38.
 - (b) it might be awkward for an entity to evaluate the costs of fulfilling a contract (i.e. the costs not in the scope of IAS 2 and IAS 16) in the context of internally-generated intangible assets for development activities. The IASB might need to consider amending IAS 38 to clarify how it applies to the recognition of an asset in the context of contracts with customers.

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Staff recommendation

62. The staff recommends that the IASB specify, in the revenue standard, the guidance in paragraphs 41–47. Similarly to the guidance proposed for U.S. GAAP, the asset would be tested for impairment (but in accordance with IAS 36).
63. If the IASB specifies the proposed guidance, the staff thinks that the guidance on inventories of a service provider in IAS 2 is not necessary and should be withdrawn.
64. The reasons for recommending that the IASB specify the proposed guidance are as follows:
 - (a) an entity would have clear guidance that directly addresses the recognition of assets from the costs incurred to fulfil a contract.
 - (b) specifying the proposed guidance will result in greater consistency between U.S. GAAP and IFRSs (although total consistency in accounting for costs to fulfil a contract will not be achieved until the Boards align their respective standards on inventory, PP&E, intangibles and impairment).

Question 2 Implications for IFRSs

The staff recommends that the IASB:

- (a) specify (in the revenue standard) the same guidance as the FASB for costs associated with contracts with customers except that an entity would test the asset for impairment in accordance with IAS 36 *Impairment of Assets*, and
- (b) withdraw from IAS 2 the guidance on inventories of a service provider.

Does the IASB agree?

Appendix A Illustrations

A1. This appendix illustrates how the proposed guidance in paragraphs 41–48 might be applied to the following examples:

- (a) Sale of goods
- (b) Construction contract
- (c) Outsourcing contract

Example 1: Sale of goods

A2. Consider the following:

Company A enters into a contract to build 10 units of a specialized asset for a customer.	
At inception, Company A expects the following:	
Revenue	\$ 1,000,000
Costs	800,000
Gross profit (20%)	200,000
At the end of the first reporting period, Company A has delivered two units and has incurred manufacturing costs of \$240,000, which includes \$100,000 of set-up and design costs for the 10 units.	

A3. Assume that revenue of \$100,000 ($\$1,000,000 \text{ transaction price} \div 10 \text{ units}$) is recognized as each performance obligation is satisfied by transferring each unit to the customer.

A4. The costs incurred to manufacture the units are eligible for capitalization in accordance with the inventory guidance in US GAAP (Subtopic 330-10) and IFRS (IAS 2). Hence, Company A would apply that guidance rather than the guidance specified in paragraphs 41–48.

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A5. Because the set up and design costs of \$100,000 relate to all inventory units, the costs would be allocated evenly to each unit (i.e. \$10,000 per unit). Thus, after transferring two units, Company A would have an inventory asset with a carrying amount of \$80,000 ($\$100,000 - \$10,000 \text{ per unit} \times \text{two units}$).

A6. At the end of the reporting period, Company A would report the following:

	\$
Revenue	200,000
Cost of goods sold	160,000
Gross profit	40,000
Inventory	80,000

Example 2: Construction contract

A7. Consider the following:

Company C enters into a contract to build a bridge on the customer's land for \$2,500,000 at an estimated cost of \$2,000,000, which consists of the following:	
	\$
Direct materials	1,000,000
Direct labour	400,000
Subcontracting costs	500,000
Mobilization (set up of equipment and workforce)	100,000
After the first year, the bridge is 50% complete. Company C had expected to incur costs of \$1,050,000 (\$100,000 mobilization + \$950,000 of other costs). However, Company C has incurred \$1,150,000 because of inefficiencies in the construction process.	

A8. In accordance with the guidance in paragraphs 41–48, Company C would recognize an asset for the \$100,000 of mobilization costs. Those costs (a) relate directly to the specific contract, (b) relate to unsatisfied performance obligations in the contract,

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and (c) are probable of recovery. That asset would be amortized in accordance with the pattern of transfer of goods and services.

A9. Company C would not recognize an asset for the \$100,000 cost variance due to inefficiencies in Company C's performance.

A10. After the first year, Company C would report the following:

	\$
Revenue (50% of \$2,500,000)	1,250,000
Cost of goods sold ¹	1,100,000
Gross profit	150,000
WIP	50,000
¹ \$1,100,000 = \$1,150,000 costs incurred less \$50,000 (50% of the asset amortization)	

Example 3: Outsourcing contract

A11. Consider the following:

Company D enters into a contract to outsource the customer's IT datacenter for five years. Before providing the services, Company D will design and build an IT platform that interfaces with the customer's systems. That platform is not transferred to the customer.	
The customer promises to pay a fixed fee of \$20,000 per month.	
Initial set-up costs incurred are as follows:	
	\$
Design	40,000
Hardware and software	210,000
Migration and testing of datacenter	100,000
Total	350,000

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- A12. Assume that Company D recognizes revenue of \$20,000 per month as services are provided.
- A13. The initial set-up costs relate primarily to activities of Company D to fulfil a contract but that do not transfer goods and services to the customer. Company D would account for the initial set-up costs as follows:
- (a) *Hardware costs*—accounted for in accordance with guidance on property, plant, and equipment (Topic 360 and IAS 16).
 - (b) *Software costs*—accounted for in accordance with guidance on recognition of intangible assets (Topic 350 and IAS 38).
 - (c) *Costs of the design, migration, and testing of datacenter*—these costs would be eligible for capitalization in accordance with the guidance in paragraphs 41–48. That asset would be amortized in accordance with the pattern of transfer of outsourcing services to the customer.