Project **Revenue Recognition**

Topic **Cost guidance associated with contracts with customers**

Introduction

1. This paper considers whether specific cost guidance is needed in accounting for contracts with customers.

Summary of recommendations

2. The staff recommends that:

   (a) The Boards reaffirm their preliminary view that costs should be recognized as expenses when incurred unless they are eligible for capitalization in accordance with other standards.

   (b) The revenue recognition project should not address existing cost guidance in other standards.

Background

3. In the Discussion Paper, the Boards explained that they do not intend the new revenue recognition standard to include specific guidance on cost recognition. Consequently, costs would be recognized as expenses when incurred unless they are eligible for capitalization in accordance with other standards (eg standards on inventory and intangible assets).

Structure of paper

4. This paper is organized as follows:

   (a) General feedback from respondents on contract costs

   (b) What cost recognition guidance would be withdrawn by the revenue standard?

   (c) What is the effect of withdrawing the cost recognition guidance in existing revenue standards?

General feedback from respondents on contract costs

5. Many respondents to the discussion paper indicated that they would be concerned if the Boards issued a revenue standard without also providing cost recognition guidance. Various reasons were given for retaining cost guidance. For instance, it was noted that many users, particularly in the construction industry, are interested in profit recognition rather than revenue recognition, and therefore the provision of guidance on cost recognition is as important as guidance on revenue recognition. Other respondents were concerned that they would lose the cost guidance that had been specifically developed for their industry.

6. Some respondents suggested that cost guidance should be considered in a separate project and others thought that cost guidance should be addressed as part of the revenue recognition project. Some of those respondents suggested that the Boards should review the cost guidance contained in existing revenue standards to determine whether the guidance should still be required or permitted or whether it is no longer acceptable.

> Most participants are of the opinion that the Boards must consider cost recognition in this project. Revenues and costs are both sides of the same coin when it comes to measuring profitability, and focusing solely on one side might lead to unintended consequences and reduced comparability in reported earnings. It was noted that the removal of the detailed revenue recognition rules that currently exist under US GAAP might also result in a loss of guidance on how to account for the related costs in some instances. This would presumably necessitate replacement guidance and clear disclosures

> of these cases, absent a more rigorous consideration of cost recognition for the project as a whole. More broadly, it was generally agreed that there was concern over a potential lack of consistency in the amount and timing of cost recognition. (Corporate Reporting Users Forum)

7. Despite these comments, the staff thinks that revenue recognition should remain the focus of this project. Although there will be some changes in practice arising from the withdrawal of some cost guidance, the analysis presented below indicates that there should be many types of contract costs that can continue to be capitalized under other standards.

What cost recognition guidance would be withdrawn by the revenue standard?

8. Many respondents said they were unclear about what the Boards meant by proposing that contract costs should be accounted for in accordance with "other standards".

9. Those respondents are primarily those who apply US GAAP. At the time the Discussion Paper was published, US GAAP contained numerous revenue standards, many of which were specific to particular industries or transactions. Some of those standards also include guidance on accounting for contract costs. Therefore, respondents were not clear whether the FASB would withdraw only the revenue recognition requirements from those standards when it issued the new revenue recognition standard, or whether it would withdraw the standards in their entirety, including the cost recognition guidance.

10. Similarly, some respondents were not clear whether the IASB would withdraw the cost recognition requirements in IAS 11 *Construction Contracts* and IAS 18 *Revenue* when the new revenue recognition standard is issued.[1]

11. Since publication of the Discussion Paper, the FASB completed the codification project. This has identified and codified most of the cost recognition guidance

[1] There is minimal cost guidance in IAS 18 and it relates only to loan origination and investment management costs.

separately from the revenue recognition guidance. For example, the cost guidance provided by SFAS 51 *Financial Reporting by Cable Television Companies* is now in FASB Accounting Standards Codification Topic 922 *Entertainment—Cable Television* and the related revenue recognition guidance is in ASC Topic 605 *Revenue*.

12. The staff thinks that the new revenue recognition standard should lead the Boards to withdraw any remaining cost guidance in ASC Topic 605 and in IAS 11 and IAS 18. This would mean that entities would look to other standards for cost recognition guidance. In IFRSs, other standards include IAS 2 *Inventories* and IAS 38 *Intangible Assets*. In US GAAP, cost guidance is provided for many industries along with inventory (ASC Topic 330), software (ASC Topic 985), property, plant & equipment (ASC Topic 360) and intangibles (ASC Topic 350).

13. The staff thinks that the FASB should retain the cost recognition guidance that is outside of ASC Topic 605, including the guidance that was sourced from standards that also included revenue guidance before the Codification. Nevertheless, the staff will review that cost guidance to check whether the basis for cost recognition is driven by the revenue recognition requirements that were previously located in those standards. If that was the case, the staff will consider whether the FASB should make any consequential amendments to that guidance when the revenue standard is issued.

Question 1 – Accounting for costs in other standards
The staff recommends that the revenue recognition project should not address existing cost guidance outside IAS 11, IAS 18 and ASC Topic 605. Do the Boards agree?

Withdrawing the cost recognition guidance from existing revenue standards

14. Cost guidance in revenue standards can be divided into the following categories:

    (a) Contract acquisition costs

    (b) Pre-contract costs

(c) Pre-performance costs

Appendix A identifies some of the cost guidance contained in revenue standards. (If Board members would like a copy of the text of all the cost guidance, please contact the project staff.)

15. This section of the paper considers the effect of withdrawing that specific cost guidance and requiring entities to apply the general cost guidance that exists in other standards.

Contract acquisition costs

16. Revenue standards that contain guidance on the treatment of contract acquisition costs include the following:

    (a) ASC Section 605-20 (about separately priced warranty and product maintenance contracts), which requires that costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and amortised in proportion to the revenue recognized.

    (b) ASC Subtopic 922-605 (about cable television entities), which requires that initial hookup revenue should be recognized as revenue to the extent of direct selling costs incurred. Any remaining direct selling costs that are in excess of initial hookup revenue should be deferred.

Staff analysis

17. If that guidance is withdrawn as a result of the revenue recognition standard, an entity would:

    (a) (typically) recognize contract acquisition costs as expenses as incurred, because those costs would not be expected to create a separate asset; and

    (b) recognize revenue at contract inception only if a performance obligation is satisfied at contract inception. Furthermore, the amount of revenue that is recognized would be based on the allocation of the transaction price.

18. Very few respondents, other than insurance-related entities, disagreed with the Boards' conclusion that revenue should not be recognized at contract inception to cover contract acquisition costs. However, more respondents disagreed with the Boards' conclusion that contract acquisition costs should be expensed as incurred. For instance, some argued net contracts assets could be recognized at inception at cost, including any costs directly attributable to obtaining the contracts.

19. The Boards have discussed contract acquisition costs extensively in both the revenue recognition and insurance contracts projects, most recently at the October 2009 joint meeting. At that meeting, the IASB tentatively amended its earlier decision for insurance contracts so that the treatment of acquisitions costs would be consistent with the FASB's decision on insurance and also with the Boards' preliminary views on revenue recognition. Accordingly, the Boards' confirmed their tentative decision that:

    (a) revenue is recognized *only* when a performance obligation is satisfied; and

    (b) the costs associated with contracts with customers should be recognized as expenses when incurred unless they are eligible for capitalization in accordance with other standards.

20. The staff does not think that the feedback from respondents highlights any new arguments that have not been considered by the Boards in their extensive deliberations of this topic. Accordingly, the staff does not think that that eliminating the guidance for contract acquisition costs in existing revenue recognition standards raises any issues that the Boards have not previously considered.

Pre-contract costs

21. Some existing cost guidance in revenue standards relates to pre-contract costs (ie costs incurred prior to signing the contract). Most of this guidance relates to

accounting for construction contracts. ASC Subtopic 605-35 *Revenue Recognition—Construction-Type and Production-Type Contracts* and IAS 11 state that:

(a) pre-contract costs can be capitalized only if it is probable that:

(i) the contract will be obtained; and

(ii) the costs will be recoverable;

(b) pre-contract costs must relate directly to a specific contract, which implies that indirect costs and overheads that are allocable across a range of activities would not be capitalized; and

(c) pre-contract costs that are expensed as incurred cannot be included in the cost of the contract asset in a subsequent reporting period.

22. In addition, IAS 11 requires that for pre-contract costs to be capitalized and included in a contract cost asset, those costs must be incurred in securing the contract and can be separately identified and measured reliably. Therefore, the types of pre-contract costs that can be capitalized are typically the direct costs associated with a contract bid. These costs can include design costs, legal and consultancy fees, and the costs of preparing and printing the bid documentation.[2]

23. ASC paragraphs 605-35-25-39(a) and 41(a) identify the “costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract” as examples of pre-contract costs that can be capitalized if the criteria in paragraph 21 above are satisfied. Furthermore, ASC paragraph 605-35-25-39(b) lists the costs for purchase of production equipment, materials and supplies as examples of costs that can be deferred.

[2] These examples are taken from IFRS commentaries prepared by the large international accounting firms.

Staff analysis

24. Some respondents want the Board to clarify the treatment of contract costs incurred prior to contract inception. For instance, one respondent commented that:

> Contract origination costs also need to be more clearly defined. A clear distinction needs to be made between costs associated with obtaining a contract (such as costs incurred in order to tender for a contract) and preliminary costs incurred before performing under a contract (such as system or infrastructure related costs to establish systems or infrastructure that is necessary to fulfill contracts with customers).
> (New Zealand Institute of Chartered Accountants)

25. Similarly, another respondent said:

> We consider that any Exposure Draft or new Standard should distinguish between contract costs which are directly related to the contract "hard costs", and other costs ("soft costs")… Examples of hard costs would be design, expert reports, and appointment of dedicated project manager. Examples of soft costs would be internal time in preparing proposal, marketing and presentation materials…
> (Property Council of Australia)

26. However, the staff notes that the Boards' decision on the treatment of costs incurred at contract inception (ie contract acquisition costs) would logically extend to the treatment of costs incurred prior to contract inception. Based on this decision on costs, there is no need for the proposed model to attempt to draw a distinction between these types of costs or activities. Instead, pre-contract costs would be recognized as expenses when incurred unless an asset can otherwise be recognized in accordance with other standards.

27. Existing practice in accounting for pre-contract costs will change as a result of this decision. The staff's review of existing standards shows that construction contractors are able to capitalize some types of costs incurred prior to contract inception provided that those costs satisfy the conditions mentioned above. Those standards permit costs to be capitalized based on the nature of the costs incurred and the activity being undertaken (ie bid costs or mobilization costs). The costs incurred may be identifiable—in that they can be attributed to an activity that is directly related to a future contract (eg to win the contract, to

assemble a workforce to complete the contract work)—but those costs will not necessarily create an identifiable asset at the time the costs are incurred.

28. In contrast, under the proposed model, these costs would be capitalized only to the extent that they satisfy asset recognition (or cost capitalization) criteria in other standards and the activity being undertaken would not determine the treatment of those costs. Overall, the staff expects that more costs will be recognized as expenses if they are incurred prior to contract inception. However, some costs will still be able to be capitalized. For example, pre-contract costs that could be recognized in the carrying amount of assets acquired during the tendering process include the cost of a design prepared by a consultant or the cost of some other item of acquired intellectual property. Similarly, costs incurred in contract mobilization that could be recognized in the carrying amount of an asset include the cost of materials or plant and equipment that has been purchased for use in the contract.

Pre-performance costs

29. As noted above, existing construction contract accounting standards permit costs to be capitalized based on nature of the costs incurred and the activity being undertaken rather than on whether an asset exists. It is clear that there will be an inventory-in-progress asset when construction has commenced. However, as with pre-contract costs, an entity may incur mobilization costs in advance of construction that may not be, by themselves, eligible for capitalization in accordance with existing requirements in other standards. For example:

> In general, we agree with this approach. However, we think under dedicated circumstances it might be adequate to capitalize these costs… In some cases it could be that we as a logistic company have high pre-contract start-up costs which are incurred from the time of winning or securing the contract up to the commencement of operations and services provided. These costs actually occur because we have already rendered a service. Depending on the contract, these expenses could be costs for labour, hiring or transferring staff, travel cost, cost for moving goods to warehouses, hard- and software IT-costs, any professional fees in preparing contracts, training, etc. As long as the criteria for capitalizing an asset are not met these costs have to be expensed in the income statement. (Deutsche Post DHL)

30. The staff thinks that these costs that do not otherwise satisfy asset recognition (or cost capitalization) criteria in other standards should be expensed as incurred. The existence or absence of a contract when those costs are incurred does not change the character of the costs, and therefore it is not a determinative factor for clarifying whether an asset exists and can be recognized.

31. Some respondents also indicated that they did not think that the existence or absence of a contract should determine the accounting for costs, although the staff notes that the arguments put forward by those respondents was intended to demonstrate that pre-contract costs should form part of the contract cost. For instance:

> …We recommend that pre-contract costs be included as part of the total contract costs since the required services in the stated contract would not have been made possible without the conceptualization and planning performed during the pre-contract activities. In many cases, a significant portion of the pre-contract costs are incurred by the performance of professional engineering activities that will ultimately benefit the proposed project, such as conceptualization, preliminary design and technical specification, and cost estimation. Hence, because such costs are integral and necessary to the ultimate completion of the project and may be material to the financial statements, they should be deferred. Separating the pre-contract costs would not be a fair representation of the true cost and income of a contract, and in measuring when a net position of a contract becomes onerous.
> (URS)

Costs that are incurred in relation to future contracts

32. ASC section 605-35-25 also provides guidance on accounting for costs when there is an existing contract but the costs relate to a future contract. This includes, for example, accounting for learning and start-up costs incurred in connection with an existing contract when follow-on or future contracts are also anticipated. The issue being addressed by this guidance is whether those costs are attributable to the existing contract or a future contract; not whether those costs should be capitalized or expensed. Accordingly, this issue is not considered further in this paper.

Conclusion

33. In the absence of specific cost recognition guidance, preparers will need to consult the asset recognition (and cost capitalization) criteria in other standards. This will include standards on inventory, intangibles, software, and property, plant & equipment. If no standards specifically apply, the entity would have to develop an accounting policy for those costs and, in many cases, this will have the consequence of requiring those costs to be recognized as expenses when incurred.

34. The staff thinks that many of the costs that are capitalized in accordance with IAS 11 and ASC Subtopic 605-35 would qualify as inventory under IAS 2 and ASC Topic 330 *Inventory*. Therefore, if the cost guidance in IAS 11 and ASC Topic 605 were eliminated, this would most likely not change the existing accounting for these costs because they would still be eligible for capitalization.

Question 2– Accounting for costs in revenue standards
The staff recommends that the Boards reaffirm their preliminary view that costs should be recognized as expenses when incurred unless eligible for capitalization in accordance with other standards. Do the Boards agree?

Appendix A: Cost guidance in existing revenue standards

A1. Cost recognition guidance contained in existing revenue standards includes:

(a) services, related to separately priced extended warranty and product maintenance contracts and fees for guaranteeing a loan (refer ASC Subtopic 605-20)

(b) construction-type and production-type contracts (refer ASC Subtopic 605-35 and IAS 11)

(c) principal agent considerations (refer ASC Subtopic 605-45)

(d) contractors to the US federal government (refer ASC Subtopic 912-605)

(e) cable television operations (refer ASC Subtopic 922-605)

(f) casinos (refer ASC Subtopic 924-605)

(g) films (refer ASC Subtopic 926-605)

(h) loan origination and investment management (refer IAS 18)

(i) insurance (refer ASC Subtopic 944-605)

(j) investment companies (refer ASC Subtopic 946-605)

(k) mortgage banking (refer ASC Subtopic 948-605)

(l) franchisors (refer ASC Subtopic 952-605)

(m) not-for-profit entities (refer ASC Subtopic 952-605)

(n) real estate—general (refer ASC Subtopic 970-605)

(o) real estate—retail land (refer ASC Subtopic 976-605)

(p) real estate—time sharing activities (refer ASC Subtopic 978-605)

(q) software (refer ASC Subtopic 985-605).