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Staff Paper

FASB Education Session
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Project **Revenue from Contracts with Customers**

Topic **Fulfillment costs**

Introduction and purpose

1. This paper considers improvements to the proposed guidance in the Exposure Draft, *Revenue from Contracts with Customers* (ED) on accounting for the costs incurred to fulfill a contract with a customer. Issues related to impairment of an asset recognized under that guidance and disclosures will be discussed at a future Board meeting.

2. This paper does not consider issues related to the costs of obtaining a contract. The Boards discussed those issues at the February 2011 meeting and tentatively decided that an entity should recognize an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.

Staff recommendations

3. The staff recommends that the Boards affirm the proposal in the ED that an entity should first apply the requirements of other standards (e.g. on inventory, PP&E, and intangibles) to account for the costs of fulfilling a contract. If an entity incurs costs to fulfill a contract and those costs are not in the scope of another standard, the entity should recognize an asset arising from fulfillment costs if all of the following conditions are met:

   (a) The costs relate directly to a contract,

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(b) The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and

(c) The costs are expected to be recovered.

4. The staff also recommends that the final standard:

(a) Clarify that "costs relating directly to a contract" include pre-contract fulfillment costs that relate directly to a specific anticipated contract.

(b) Describe abnormal costs as additional fulfillment costs that were not considered in the price of the contract and that will not be reimbursed by the customer (hence, they do not generate or enhance resources of the entity).

(c) Include more examples of allocations of costs that relate directly to a contract.

Structure of paper

5. This paper is organized as follows:

(a) Background information (paragraphs 6–14)

(b) Scope of the guidance on costs (paragraphs 15–35)

(c) Pre-contract costs (paragraphs 36–49)

(d) Abnormal costs (paragraphs 50–54)

(e) Direct costs (paragraphs 55–60)

(f) Learning costs (paragraphs 61 – 79)

(g) Appendix A – Existing guidance on setup costs

(h) Appendix B – Existing guidance on pre-contract costs

(i) Appendix C – Existing guidance on learning costs.

Background information

Why the Boards decided to include fulfillment cost guidance in the ED

6. The December 2008 Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers,* focused on how an entity should recognize revenue in a contract and, hence, did not propose guidance on how an entity should account for the costs to fulfill a contract.

7. The Boards subsequently decided to develop guidance in the ED on the costs of fulfilling a contract for the following reasons:

   (a) *Consequential amendments*: the Boards agreed with respondents to the Discussion Paper who thought that it was not possible to develop a comprehensive revenue standard without addressing at least some of the cost guidance that inevitably would be affected by the revenue standard.

   (b) *Convergence*: more costs would be accounted for similarly under U.S. GAAP and IFRSs (although total consistency in accounting for costs to fulfill a contract would not be achieved until the Boards align their respective standards on inventory, PP&E, intangibles and impairment).

   (c) *Clarification*: entities would have clearer guidance to account for some costs to fulfill a contract (e.g. setup costs for services).

   (d) *Consistency*: entities that currently are allowed to select from various methods of accounting for setup costs under Subtopic 605-10 would be required to apply one method of accounting for those costs.

8. In US GAAP, the guidance on costs to fulfill a contract that would be superseded by the final revenue standard includes:

   (a) Subtopic 605-35 on costs associated with construction and production-type contracts (that guidance also is applied to some software development contracts).

   (b) Subtopic 605-10-S99 (formerly SAB 104) on setup costs, which allows companies to choose between several different methods of

accounting for those costs. Entities may choose one of the following methods:

(i) Recognize an asset by analogy to the guidance in Subtopic 605-20 on the costs of obtaining separately priced extended warranty and product maintenance contracts,

(ii) Recognize an asset by analogy to the guidance in Subtopic 310-20 on direct loan origination costs, or

(iii) Expense setup costs as they are incurred.

9. In IFRSs, IAS 11 includes fulfillment cost guidance that would be eliminated by the ED. Without developing further guidance on fulfillment costs in the revenue project, entities would have been required to evaluate costs in accordance with IAS 38, *Intangible Assets,* which was not developed for the specific context of contracts with customers. As a consequence of developing guidance on fulfillment costs, the guidance in IAS 2, *Inventories,* on the cost of inventories of a service provider also would be superseded.

Summary of proposed guidance on costs of fulfilling a contract

10. The ED proposed that if the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with another IFRS (for example, IAS 2, *Inventories*) or Topic (for example, Topic 360 on property, plant, and equipment), an entity should recognize an asset only if those costs:

(a) Relate directly to a contract (or a specific contract under negotiation)

(b) Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (i.e. the costs relate to future performance); and

(c) Are expected to be recovered.

11. The ED also proposed that costs that relate directly to a contract are:

(a) Direct labor (for example, salaries and wages of employees who provide services direct to the customer);

(b) Direct materials (for example, supplies used in providing services to the customer);

(c) Allocations of costs that relate directly to the contract or contract activities (for example, costs of contract management and depreciation of tools and equipment used in fulfilling the contract);

(d) Costs that are explicitly chargeable to the customer under the contract; and

(e) Other costs that were incurred only because the entity entered into the contract (for example, subcontractor costs).

12. The ED proposed that an entity should recognize the following costs as expenses when incurred:

(a) Costs that relate to satisfied performance obligations in the contract (that is, the costs that relate to past performance obligations); and

(b) Costs of abnormal amounts of wasted materials, labor, or other resources to fulfill the contract.

Summary of comments received

13. Most respondents were supportive of the ED's proposed guidance on the costs of fulfilling a contract, and concluded it was understandable and that it would result in the appropriate costs being capitalized. Those who supported the proposed guidance noted that it would enhance convergence and improve on existing guidance that would be superseded by the ED. Respondents noted the following:

> We appreciate that the Board has included guidance in the proposed standard regarding contract costs that may be recognized in fulfilling performance obligations. We believe retaining this guidance is critical because the proposed standard will supersede existing U.S. GAAP that specifically supports deferral of certain costs related to work-in-process on long-term construction / production-type contracts that is not contained in other standards that will remain in effect after the adoption of the new standard. [Raytheon]

> We commend the Boards on the guidance regarding cost recognition and are supportive of these proposed criteria for

> distinguishing when to expense versus capitalise contract costs. We believe capitalising of costs directly related to fulfilling a contract is appropriate. [The CFA Institute]

14. Despite the general support for the ED's proposals, respondents raised issues relating to the following:

    (a) Scope of the cost guidance,

    (b) Pre-contract costs,

    (c) Abnormal costs,

    (d) Direct costs, and

    (e) Learning costs.

Scope of the guidance on fulfillment costs

Clarification of the scope of the ED

15. The ED included the following scope for recognizing an asset arising from the costs of fulfilling a contract:

> If the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with another IFRS/Topic, an entity shall recognize an asset only if those costs…

16. Most respondents to the ED supported the scope of the proposed cost guidance and commended the Boards for developing guidance that they thought would improve financial reporting.

17. Some of those respondents, however, asked the Boards to improve the drafting of the scope of the cost guidance to clarify the Boards' intention. For example, respondents questioned whether an asset should be recognized if an entity incurs a cost that meets the definition of an asset under the proposed requirements of the ED, but another Topic/IFRS would require that incurred cost to be recognized as an expense.

18. The staff thinks that it was not the Boards' intention for an entity to recognize an asset in accordance with the ED for costs that another standard would require an entity to recognize as an expense. Hence, the staff thinks the

introductory scope paragraph for the fulfillment cost guidance should be clarified as follows:

> If another IFRS/Topic provides guidance on accounting for fulfillment costs, an entity shall apply the guidance in that IFRS/Topic. If an entity incurs a cost to fulfill a contract that is not covered by other IFRSs/Topics, the entity shall apply the guidance in this IFRS/Topic.

Requests that the Boards address costs comprehensively

19. Some respondents recommended that the Boards address cost guidance comprehensively in a separate project (preferably in a project that would be undertaken concurrently with the revenue project). Some of those respondents think that existing standards on inventory, PP&E, and intangibles should be improved and converged which would eliminate the need for the revenue project to develop cost guidance.

20. Consider the following responses:

> Holcim does not believe that it is appropriate that a revenue recognition standard should include requirements about costs incurred in fulfilling a contract. Instead, they should be included as consequential amendments in standards on IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets respectively. [Holcim Group Support Ltd]

> We believe that cost guidance ideally should not be included in a revenue standard. It should be included in other standards that contain asset or cost guidance. We also believe that the costs of fulfilling a contract that do not meet the definition of an asset under IFRS or U.S. GAAP should not be capitalized, even if they are incurred solely as a result of entering into a contract. [PricewaterhouseCoopers]

21. Despite the recommendation that the Boards address cost guidance more comprehensively, some of those same respondents indicated that they would accept the ED's proposed guidance as an interim step until the time when the Boards could comprehensively address the accounting for costs associated with contracts with customers. For example:

> Apart from the comments above, Holcim believes that the requirements on accounting for the costs of fulfilling a

> contract are operational and sufficient. [Holcim Group Support Ltd]
>
> We therefore accept the inclusion of cost guidance in the revenue standard at this stage, but we recommend that the boards comprehensively review the cost guidance that exists under both IFRS and U.S. GAAP to ensure that the guidance is sufficient to accomplish the boards' objectives. [PricewaterhouseCoopers]

22. In February 2011, the Boards considered whether to address costs comprehensively as part of the revenue project. The Boards decided to not address costs comprehensively at this time. However, the staff notes that the location of the final cost guidance developed as part of the revenue project does not necessarily have to be in the revenue standard. Rather, it could be located in other standards such as IAS 2, *Inventories* or Topic 340 on other assets and deferred costs.

Narrow the scope of the cost guidance

23. As discussed in paragraphs 6–9, the Boards decided to develop cost guidance in the ED primarily to address concerns about the effect of the revenue model on existing requirements for setup costs for services contracts and for construction and production-type contracts. Hence, the staff considered the following alternatives to the ED's proposed scope:
    (a) *Alternative A:* Limit the ED's cost guidance to performance obligations satisfied continuously
    (b) *Alternative B:* Limit the ED's cost guidance to construction and production-type contracts

Alternative A: Limit the cost guidance to performance obligations satisfied continuously

24. Alternative A, limiting the ED's cost guidance to performance obligations satisfied continuously, was suggested by a couple respondents to the ED. Those respondents recommended that the Boards focus on improving cost guidance for services because that was the targeted area of improvement to existing requirements (e.g. the FASB was concerned about entities being

required to rely on weak analogies when accounting for setup costs for a services contract).

25. However, Alternative A would not improve convergence for performance obligations not satisfied continuously because of differences between US GAAP and IFRSs. For instance, an entity might incur setup costs for a performance obligation that is not satisfied continuously but those costs do not give rise to tangible inventory. In that instance, the entity might recognize an asset in accordance with IAS 2 (because the IFRS definition of inventory is not limited to tangible items) whereas the entity would not be in the scope of inventory guidance in US GAAP which limits inventory to tangible items.

Alternative B: Limit the cost guidance to construction and production-type contracts

26. Alternative B would limit the ED's cost guidance to construction and production-type contracts (those entities currently within the scope of IAS 11 and Subtopic 605-35). Guidance on cost of inventories of a services provider in IAS 2 would be retained, and current SEC guidance on setup costs in Subtopic 605-10-S99 (see Appendix A) would be moved to Topic 340-10, Other Assets and Deferred Costs.

27. This alternative would improve convergence for construction and production-type contracts using guidance that is similar to existing requirements for those contracts.

28. However, Alternative B would require entities applying US GAAP to continue relying on weak analogies for setup costs. Additionally, it would not address the concerns of the respondents who recommended improving the guidance on cost of inventories of a service provider in IAS 2.

Staff recommendations

29. The majority of the staff recommend that the Boards affirm the scope of the cost guidance proposed in the ED. Those staff members highlight that the Boards decided to include cost guidance in the ED to improve convergence, eliminate weak analogies in U.S. GAAP, and improve consistency in the accounting for costs to setup and fulfill a contract. Responses to the ED were

generally supportive of the proposed cost guidance and think that the proposals would achieve the Boards' objective. Even some of those respondents who ask the Boards to consider cost guidance comprehensively highlight that they accept the proposed cost guidance and think it would be operational and sufficient.

30. Therefore, the majority of the staff believe the Boards should not reconsider including this guidance as part of another more comprehensive project on the accounting for costs. Rather, the Boards should carry forward the guidance from the ED (subject to the improvements discussed in this paper).

Alternative staff view

31. One staff member recommends Alternative B in paragraph 26. The staff member agrees with respondents who stated that cost guidance should be addressed comprehensively. The staff member believes that the guidance in the ED will result in a significant change to the accounting for some fulfillment costs under U.S. GAAP. Until the time when the Boards can address the accounting for fulfillment costs comprehensively, the staff member thinks the Boards should focus on filling the gap in existing guidance that would be created by the final standard. That gap relates to setup costs and fulfillment costs associated with construction and production-type contracts.

32. For setup costs, Subtopic 605-10-S99 (see Appendix A) permits an entity to either recognize an expense for initial setup costs when they are incurred, or to recognize an asset by analogizing to guidance on loan origination and warranty acquisition costs. The staff member notes that this guidance permits an asset to be recognized only for initial setup costs, but does not address fulfillment costs incurred after that initial setup.

33. The staff member believes that this is significantly different from the ED's guidance, which would require an entity to recognize an asset for some fulfillment costs that occur after initial setup costs are incurred. Additionally, an entity would not have the option of recognizing an expense for setup costs when they are incurred (if those costs meet the ED's criteria to be recognized as an asset).

34. Although the Boards may have intended to make those changes to existing guidance and most respondents supported the proposals, the staff member is concerned for the following reasons:

    (a) The usefulness of recognizing assets arising from the costs of acquiring or fulfilling a contract is questionable because in many cases they do not 'arise' as management expected. This may be due to changing industry dynamics and competition, or excessive optimism in future projections.

    (b) Eliminating volatility in earnings by matching current costs with the future revenues to which they are supposed to relate is not achieved in the instances where volatility is created through asset impairments (i.e. the volatility is on the back end instead of the front end of the transaction).

    (c) Assets recognized based on management's expectation that current cash outflows will be recovered through future cash inflows are the lowest quality assets on an entity's balance sheet. When a CFO reaches for those assets (e.g. because the entity needs to sell assets for cash), they are not there.

    (d) The fulfillment cost guidance in the ED could result in a higher frequency of asset impairments than under current guidance.

35. For those reasons, the staff member believes that comprehensive research should be conducted before changing existing accounting for fulfillment costs. That research should address the following issues:

    (a) For those entities that currently recognize assets for pre-contract and setup costs, whether those costs are recovered by a majority of those entities.

    (b) How entities interpret existing guidance on recognizing assets arising from costs that are "expected to be recovered" versus costs that are "probable of being recovered" (e.g. do entities recognize an asset based on their past experience of recovering the same types of costs, or is past performance not a necessary indicator?).

(c) Whether the frequency of asset impairments under existing U.S. GAAP is actually understated given that there is no requirement to impair assets based on an opportunity cost notion. An investor's opportunity cost for its at-risk investment in an entity is the risk-free rate of return from owning long-term government bonds. That is, a rational investor would seek to generate a return in any at-risk investment greater than the risk-free rate of return. Therefore, the requirement that an entity merely recover current cash outflows with future cash inflows (without generating any return) seems to be an inadequate requirement for defining an asset arising from the costs incurred in fulfilling a contract.

Question for the Boards

Question 1
Do the Boards agree with the majority staff view and recommendation to retain the existing scope in the ED for the fulfillment cost guidance rather than addressing costs comprehensively?

Pre-contract fulfillment costs

36. Pre-contract costs are fulfillment costs that an entity incurs prior to obtaining a contract, such as the costs of mobilization, engineering and design, architectural, or other fulfillment costs incurred on the basis of commitments or other indications of interest in negotiating a contract (see Appendix B for existing guidance in IFRS and U.S. GAAP on precontract costs).

37. In accordance with Subtopic 605-35 on construction contracts, an entity would recognize an asset for pre-contract costs if the costs are directly associated with a specific anticipated contract and if their recoverability from that contract is probable. IAS 11 requires an entity to recognize an asset for the costs incurred in securing a contract if:

    (a) They relate directly to a contract,

    (b) They can be separately identified and measured reliably, and

(c) It is probable that the contract will be obtained.

38. Some respondents, including both public and private entities, asked the Boards to clarify the guidance on pre-contract costs in the ED. They questioned whether the wording "or a specific contract under negotiation" in paragraph 57(a) of the ED, which states that an entity shall recognize an asset only if the costs relate directly to a contract (or a specific contract under negotiation), is intended to encompass the guidance in Subtopic 605-35 on pre-contract costs. They recommended either retaining existing guidance on pre-contract costs in Subtopic 605-35, or adding guidance that would clarify that some pre-contract costs are eligible for capitalization, such as engineering and design costs, that provide a benefit to the entire project and are expected to be recovered from future cash flows.

39. A few respondents recommended that an entity not recognize an asset for pre-contract fulfillment costs. Some of those respondents questioned how an entity could recognize an asset prior to obtaining a contract, while others were more concerned about the implementation costs of having to identify which pre-contract costs should be capitalized.

40. In response to those concerns, the staff considered the following alternatives for pre-contract costs:

    (a) *Alternative A:* Improve the ED's cost guidance based on respondents' comments

    (b) *Alternative B:* Improve the ED's cost guidance based on respondent's comments, but limit the guidance to contracts that currently are in the scope of IAS 11 and Subtopic 605-35.

41. Alternative A would address respondents' concerns about pre-contract costs by clarifying that an entity should recognize an asset for pre-contract costs if those costs:

    (a) relate directly to a specific anticipated contract,

    (b) generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and

    (c) are expected to be recovered.

42. This is similar to the following guidance on pre-contract costs in Subtopic 605-35 (see Appendix B for all of the guidance on pre-contract costs):

> 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.

43. To clarify the similarity to existing requirements, proponents of Alternative A would use wording in the final standard that is more consistent with existing requirements (e.g. "specific anticipated contract"). Alternative A would improve convergence and develop consistent requirements for pre-contract costs across all industries, rather than maintaining specialized guidance for the long-term construction and production-type contracts.

44. Alternative B would limit the guidance on pre-contract costs to those entities that follow similar guidance in Subtopic 605-35 and IAS 11. However, Alternative B would not result in consistent guidance on pre-contact costs across all industries because it would be limited to construction and production-type contracts, which would require the Boards to develop a common definition for a particular class of contracts.

Staff recommendations

45. The majority of the staff recommend Alternative A. Providing explicit guidance on costs incurred before a contract is signed would address respondents' concerns about whether those costs are eligible to be capitalized. The staff believes this clarification would eliminate confusion around the language "specific contract under negotiation" and improve consistency in applying the fulfillment cost guidance.

46. The staff note that most pre-contract costs are incurred for construction and production-type contracts. Hence, the majority of the staff are not concerned about expanding 'precontract' cost guidance to entities that at present do not apply the guidance on precontract costs for construction and production-type contracts.

47. Additionally, Alternative A would improve convergence of existing guidance in IAS 11 and Subtopic 605-35. Specifically, both of those standards require an entity to recognize an asset arising from pre-contract costs/costs of securing a contract if those costs:

    (a) Relate directly to the contract and

    (b) Are probable of being recovered.

Alternative staff view

48. One staff member recommends Alternative B. The staff member does not see the justification for expanding that guidance to all entities within the scope of the final standard, thus requiring some pre-contract costs to be capitalized when in current practice they are expensed.

49. The staff member with this alternative view also believes that the existing requirements that allow an entity to recognize an asset arising from precontract costs are not interpreted in practice consistently. Therefore, carrying forward those existing requirements (or guidance similar to those requirements) in the final standard would result in those requirements being continued to be applied inconsistently, but by more entities than at present.

Question 2
The staff recommends that the final standard carry forward the guidance in the ED that would require an entity to recognize an asset for pre-contract costs if those costs: 1) Relate directly to a contract (or a specific anticipated contract) 2) Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and 3) Are expected to be recovered. Do the Boards agree?

Abnormal costs

50. The ED required an entity to recognize an expense for the costs of abnormal amounts of wasted materials, labor, or other resources used to fulfill a contract because those costs do not generate or enhance resources of an entity. That guidance in the ED is similar to the existing guidance for inventory. For example, IAS 2 requires an entity to recognize an expense for the following costs of inventories:

> Abnormal amounts of wasted materials, labor or other production costs

51. Some respondents requested further clarification of what is meant by an "abnormal cost". One respondent noted the following:

> Abnormal costs should not include costs as the result of a contract renegotiation or contract modification. Abnormal costs should also not include a revision of an estimate for a type of cost that was identified in the negotiation/bid process. Abnormal costs should be those that are truly out of the ordinary and not something that is part of the direct deliverable to the customer. [Dell]

52. Other respondents noted that in many cases abnormal costs are actually a normal part of fulfilling a contract, are planned for, and are priced into the contract. They noted that it is difficult to identify which costs are "abnormal costs" under the existing definition given that some of those costs are anticipated at the outset of a contract. Other respondents noted that a customer may agree to reimburse cost overruns, or a contract might be renegotiated due to unexpected costs.

53. The staff agrees that it may not be appropriate to expense the cost of wasted materials in situations where cost overruns are expected and priced into the contract, or a customer agrees to renegotiate the contract price.

54. Consequently, the staff thinks the final standard should include additional guidance to clarify what is meant by an 'abnormal cost'. The standard could clarify that abnormal costs are additional fulfillment costs that were not considered in the price of the contract and that will not be reimbursed by the customer. Those costs do not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Question 3
The staff recommends that the final standard clarify what is meant by an 'abnormal cost'. The staff thinks abnormal costs are additional fulfilment costs that were not considered in the price of the contract and will not be reimbursed by the customer. Do the Boards agree?

Direct costs

55. Some respondents requested more guidance on direct costs, and in particular, which allocated costs should be considered "direct". Some of those respondents recommended that the guidance in IAS 11 should be used for cost capitalization, which states that "costs that are attributable to contract activity in general and can be allocated to the contract". Respondents also recommended including more examples of indirect or overhead type costs used in IAS 11 or Subtopic 605-35, such as indirect labor, contract supervision, supplies, and insurance.

56. Other respondents recommended clarifying that costs explicitly chargeable to the customer would include any bid and ask costs that a customer agrees to reimburse. Those respondents recommended this clarification because the ED required entities to recognize an expense for all costs of obtaining a contract, and included an example bid and proposal costs as an example.

57. The table on the following page compares the description of direct costs in the ED with the descriptions in IAS 11 and Subtopic 605-35 for construction and production-type contracts, and IAS 2 and Subtopic 330-10 for inventories. The staff notes that the descriptions are very similar, except that IAS 11 and Subtopic 605-35 include more examples than the ED in some instances.

Exposure Draft	Subtopic 605-35 (Construction/Production Type Contracts)	IAS 11 (Construction Contracts)	Subtopic 330-10 (Inventory)	IAS 2 (Inventory)
Direct labor (for example, salaries and wages of employees who provide services direct to the customer)	All direct costs, such as material, labor, and subcontracting costs	Site labor costs, including site supervision	Cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. However, the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities.	The costs of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. The costs of purchase of inventories comprise the purchase price, import duties and other taxes, and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Costs of conversion of inventories include costs directly related to the units of production, such as direct labor and a systematic allocation of fixed and
Direct materials (for example, supplies used in providing services to the customer	All direct costs, such as material, labor, and subcontracting costs	Costs of materials used in construction, costs of moving plant, equipment and materials to and from the contract site, costs of hiring plant and equipment		
		Costs of design and technical assistance that is directly related to the contract		
		Estimated costs of rectification and guarantee work, including expected warranty costs		
Allocations of costs that relate directly to the contract or contract activities (for	Indirect costs allocable to contracts include the costs of indirect labor, contract	Depreciation of plant and equipment used on the contract, insurance, costs of		

Exposure Draft	Subtopic 605-35 (Construction/Production Type Contracts)	IAS 11 (Construction Contracts)	Subtopic 330-10 (Inventory)	IAS 2 (Inventory)
example, costs of contract management and depreciation of tools and equipment used in fulfilling the contract)	supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls.	design and technical assistance not directly related to a specific contract, construction overheads		variable production overheads that are incurred in converting materials into finished goods. It may be appropriate to include non-production overheads or the costs of designing products for specific customers in the costs of inventories.
Costs that are explicitly chargeable to the customer under the contract		Costs that are explicitly chargeable to the customer under the terms of the contract		

Staff analysis and recommendation

58. The staff thinks the description of direct costs in the ED should be carried forward subject to minor drafting changes. The staff thinks the final standard should include more examples of allocations of costs that relate directly to a contract. Those examples in existing standards include supplies, insurance, and contract supervision. The staff thinks those costs are consistent with the ED's description of allocations of costs that relate directly to the contract or to contract activities.

59. In addition, the staff thinks the final standard should include bid and ask costs as an example of costs that may be reimbursable from the customer. Some respondents from the construction industry highlighted that it is not uncommon for a customer (e.g. a government) to guarantee reimbursement of specific costs associated with bidding on a contract. If those specific costs are explicitly chargeable to the customer, the staff thinks they would meet the description of a 'direct cost' even if they are an allocated amount.

60. The staff believes that a few more examples of allocations of costs (as discussed above) would be helpful in the final standard. However, the staff believes that there will always be requests for guidance on a particular situation that is not covered by specific examples. Therefore, the Boards should limit the number of additional examples provided.

Question 4
The staff recommends that the final standard include additional examples of costs that relate directly to a contract as discussed in paragraphs 58 and 59 of this paper. Do the Boards agree?

Learning costs

61. Some respondents questioned how to apply the proposed model to account for the effects of learning costs in a contract with a customer. Hence, this section of the paper analyzes that issue. However, this section of the paper does not

have a question for the Boards because the staff is not recommending any change to the revenue model.

62. The phenomenon of a 'learning curve' can be observed in many circumstances regardless of whether a contract with a customer exists. A learning curve is the effect of efficiencies realized over time when an entity's costs of performing a task (or producing a unit) decline in relation to how many times the entity performs that task (or produces that unit). For example, a typical manufacturer that produces units to inventory would become more efficient in its production process over time.

63. Some respondents questioned how to account for learning costs in a contract in which an entity produces a specified number of units in a contract with a customer (or a combination of contracts with customers) that currently is accounted for using a percentage of completion method.

64. Other respondents asked the Boards to retain the following guidance in Subtopic 605-35 on construction and production-type contracts (Appendix A summarizes existing requirements related to learning costs):

> Production-type contracts that do not meet the criteria in paragraph 605-35-25-8 or segments of such contracts may be combined into groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit costs if both of the following circumstances exist:
>
> a. The contracts are with one or more customers for the production of substantially identical units of a basic item produced concurrently or sequentially.
>
> b. Revenue on the contracts is recognized on the units-of-delivery basis of applying the percentage-of-completion method.

65. In practice, there are two main methods of accounting for the effects of a learning curve in a construction or production-type contract:

    (a) A revenue method, or

    (b) A cost method.

66. Under both methods, an entity would recognize the same gross profit percentage. However, the reported revenues and the expenses in each reporting period would differ.

Revenue method of accounting for a learning curve

67. Under a revenue method, an entity would recognize as an expense the costs of fulfilling a contract when incurred. The entity then would recognize revenue by selecting a method of measuring progress that depicts the entity's performance. In most cases, the revenue recognized would be equal to the cost incurred plus the gross profit earned during the period (i.e. an entity would select a cost-to-cost method of measuring progress). Consequently, assuming an entity produces an equal number of units each reporting period, the total amount of revenue and expense recognized each period would decline throughout the contract.

68. Consider the following example:

> An entity enters into a contract to construct 10 highly specialized units based on the specifications of the customer for a fixed price of CU15,000 . Those promised units give rise to a single performance obligation that is satisfied continuously. The entity expects to incur learning costs of CU500, CU300, and CU200 for the first, second, and third units of production, respectively. The entity estimates that all other production costs will be CU1,000 per unit.

Accounting for the first unit produced

69. The entity begins production of the first unit and incurs learning costs of CU500 and other production costs of CU1,000. The entity would recognize the following:

Revenue	2,045	[(1,500 costs incurred ÷ 11,000 total expected costs) × 15,000]
Expense	1,500	
Margin	545	(26.7%)

Accounting for the second unit produced

70. To produce the second unit, the entity incurs learning costs of CU300 and production costs of CU1,000. The entity would recognize the following:

Revenue	1,773	[(2,800 costs to date ÷ 11,000 total costs) × 15,000 – 2,045 revenue to date]
Expense	1,300	
Margin	473	(26.7%)

Accounting for the remaining units produced

71. For the production of the remaining units, the entity would continue to recognize revenue and expense as described above. The entity would report the same gross profit percentage as each unit is produced.

Cost method of accounting for a learning curve

72. Under a cost method, an entity would recognize an asset as it produces the first units in a contract. That asset would be amortized as the entity produces the later units in the contract. The effect of a cost method is that an entity would recognize the same amount of revenue and expense for each unit produced in the contract. Revenue likely would be recognized on a units of delivery method.

73. Consider the same fact pattern as above:

> An entity enters into a contract to construct 10 highly specialized units based on the specifications of the customer for a fixed price of CU15,000 . Those promised units give rise to a single performance obligation that is satisfied continuously. The entity expects to incur learning curve costs of CU500, CU300, and CU200 for the first, second, and third units of production, respectively. The entity estimates that all other production costs will be CU1,000 per unit.

Accounting for the first unit produced

74. The entity begins production of the first unit and incurs learning costs of CU500 and other production costs of CU1,000. The entity would recognize the following:

Revenue	1,500 [15,000 contract price ÷ 10 units]
Expense	1,100 [11,000 expected costs ÷ 10 units]
Margin	400 (26.7%)
Asset	400 [1,500 costs incurred – 1,100 recognized as an expense]

Accounting for the second unit produced

75. To produce the second unit, the entity incurs learning costs of CU300 and production costs of CU1,000. The entity would recognize the following:

Revenue	1,500 [15,000 contract price ÷ 10 units]
Expense	1,100 [11,000 expected costs ÷ 10 units]
Margin	400 (26.7%)
Asset	600 [2,800 costs incurred – 2,200 recognized as an expense]

Accounting for the remaining units produced

For the production of the remaining units, the entity would continue to recognize revenue and expense as described above. With production of the third unit, the asset recognized for the learning curve would increase by CU100 (CU200 learning costs when producing the third unit less CU100 learning costs attributable to the third unit). The entity then would amortize the asset at an amount of CU100 per unit for the production of the remaining seven units resulting in a recognized profit margin of CU400 per unit produced.

Staff analysis and recommendation

76. The staff thinks that the proposed model already addresses the accounting for the effects of learning costs when:

    (a) an entity has a single performance to deliver a specified number of units, and

    (b) that performance obligation is satisfied continuously.

77. In that situation, an entity would account for the learning curve effect using the revenue method described in paragraph 67. Hence, an entity would recognize revenue by selecting a method of measuring progress that depicts the continuous transfer to the customer. An entity likely would select a method (e.g. cost-to-cost) that would result in the entity recognizing more revenue and

expense for the early units produced relative to the later units. That effect would be appropriate because of the greater value of the entity's performance in the early part of the contract. If an entity were to sell just one unit, it would charge the customer a higher price for that unit than the average unit price when the customer purchases more than one unit.

78. In other situations, an entity may promise to deliver a specified number of units in a contract but that promise does not give rise to a single performance obligation that is satisfied continuously. In those situations, the staff thinks an entity should apply the requirements of other standards (e.g. inventory) for the following reasons:

    (a) If an entity incurs costs to fulfill a contract but does not satisfy a performance obligation continuously, then the entity likely would be creating an asset that would be in the scope of other standards. For example, the costs of producing tangible units would accumulate as inventory and the entity would select an appropriate method of measuring that inventory (e.g. on the basis of average costs).

    (b) The type of contract described in this paragraph is not the type of contract contemplated by Topic 605-35 and IAS 11.

79. Consequently, if an entity has a single performance obligation to deliver a specified number of units and that performance obligation is satisfied continuously, an entity should use the revenue method described in paragraph 67. Although that would change some current practice, the staff thinks it would enhance the comparability of the accounting across entities. The staff will consider developing an example to illustrate in the final standard how an entity would apply the proposed model to a single contract with a learning curve effect.

Appendix A – Existing guidance on setup costs

A1. The guidance in Subtopic 605-10-S99 on setup costs states the following:

> Facts: Company A provides its customers with activity tracking or similar services (e.g. tracking of property tax payment activity, sending delinquency letters on overdue accounts, etc.) for a ten-year period. Company A requires customers to prepay for all the services for the term specified in the arrangement. The on-going services to be provided are generally automated after the initial customer setup. At the outset of the arrangement, Company A performs setup procedures to facilitate delivery of it on-going services to the customers. Such procedures consist primarily of establishing the necessary records and files in Company A's pre-existing computer systems in order to provide the services. Once the initial customer setup activities are complete, Company A provides its services in accordance with the arrangement. Company A is not required to refund any portion of the fee if the customer terminates the services or does not utilize all of the services to which it is entitled. However, Company A is required to provide a refund if Company A terminates the arrangement early.
>
> Question: How should Company A account for the initial customer setup costs?
>
> Interpretive Response: The staff believes that the incremental direct costs (Subtopic 310-20 provides an analogous definition) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue, unless specifically provided for in the authoritative literature, may be either expensed as incurred or accounted for in accordance with paragraph 605-20-25-4 or paragraph 310-20-35-2. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

A2. IAS 2 says the following on cost of inventories of a service provider:

> To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labor and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labor and other costs relating to sales and general administrative personnel are not included but are recognized as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

Appendix B – Existing guidance on precontract costs

B1. In U.S. GAAP, Subtopic 605-35 provides guidance on the accounting for pre-contract costs, which is applicable to the following types of contracts:

> (a) Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, this Subtopic also would be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant.
>
> (b) Contracts to design and build ships and transport vessels.
>
> (c) Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
>
> (d) Contracts for construction consulting service, such as under agency contracts or construction management agreements.
>
> (e) Contracts for services performed by architects, engineers, or architectural or engineering design firms.
>
> (f) Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software. Nevertheless, transactions that normally are accounted for as products sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

B2. Under IFRS, IAS 11 is applicable to all construction contracts, which include contracts specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

B3. Pre-contract costs are deferred in anticipation of future contract sales in a variety of circumstances. Paragraph 25-39 states that the costs may consist of any of the following:

(1) Costs incurred in anticipation of a specific contract that will result in no future benefit unless the contract is obtained (such as the costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract)
(2) Costs incurred for assets to be used in connection with specific anticipated contracts (for example, costs for the purchase of production equipment, materials, or supplies)
(3) Costs incurred to acquire or produce goods in excess of the amounts required under a contract in anticipation of future orders for the same item
(4) Learning, start-up, or mobilization costs incurred for anticipated but unidentified contracts.

B4. Paragraph 25-41 recommends the following accounting for pre-contract costs:

(1) 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. Pre-contract costs that are start-up activities shall be expensed as incurred if they are determined to be within the scope of Subtopic 720-15, which provides guidance on start-up costs.
(2) Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.
(3) Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.
(4) Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.

(5) Costs appropriately deferred in anticipation of a contract shall be included in contract costs on the receipt of the anticipated contract.
(6) Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable shall not be reinstated by a credit to income on the subsequent receipt of the contract.

B5. In IFRS, paragraph 21 of IAS 11 provides the following similar guidance on costs that are incurred prior to contract inception:

> Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

Appendix C - Existing requirements that refer to learning costs

C1. This appendix summarizes existing requirements that refer to learning costs.

C2. In US GAAP, learning costs are described as follows in paragraph 25-40 of Subtopic 605-35:

> 25-40 Learning or start-up costs are sometimes incurred in connection with the performance of a contract or a group of contracts. In some circumstances, follow-on or future contracts for the same goods or services are anticipated. Such costs usually consist of labor, overhead, rework, or other special costs that must be incurred to complete the existing contract or contracts in progress and are distinguished from research and development costs.

C3. Under Subtopic 605-35, learning or startup costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services are charged to existing contracts.

C4. While IFRSs do not use the words ‘learning costs’, the staff believes similar guidance exists in paragraph 27 of IAS 11, which states:

> A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognized as an asset provided it is probable that they will be recovered.