Project **Revenue Recognition**

Topic **Accounting for costs of obtaining a contract**

Introduction and purpose

1. The purpose of this paper is to discuss issues raised by respondents to the joint Exposure Draft (ED), *Revenue from Contracts with Customers*, relating to the accounting for costs of obtaining a contract. This paper does not discuss issues related to costs of fulfilling a contract. Those issues will be discussed in future Board papers.

Summary of staff recommendations

2. The staff recommends that an entity should:
   (a) Recognize as an asset the incremental costs directly attributable to obtaining a contract that are expected to be recovered. Incremental costs are those costs that would not have been incurred if the contract had not been obtained.
   (b) Amortize the asset recognized for the incremental costs of obtaining a contract on a systematic basis consistent with the pattern of the transfer of goods or services in that contract.
   (c) Present the asset recognized for the incremental costs of obtaining a contract with the entity's contract assets.

Structure of paper

3. This paper is organized as follows:

   (a) Review of the ED's proposed guidance on costs of obtaining a contract

   (b) Summary of comments received from respondents

   (c) Alternatives

   (d) Staff recommendations.

Review of the ED's proposed guidance on costs of obtaining a contract

4. The ED proposed that all costs incurred in obtaining a contract (for example, the costs of selling, marketing, advertising, bid and proposal, and negotiations) should be expensed as incurred. That is because the asset resulting from the costs of obtaining a contract is primarily the contract asset. And the Boards decided that an entity should recognize a contract asset only as a result of satisfying a performance obligation.

Summary of comments received from respondents

5. Some preparers and auditors disagreed with the Boards' proposed guidance on the costs of obtaining a contract for the following reasons:

   (a) The proposed guidance is inconsistent with other accounting literature

   (b) Cost guidance does not belong in a revenue recognition standard

   (c) Some costs of obtaining a contract result in future benefits that represent an asset

   (d) The proposed guidance is inconsistent with other Exposure Drafts.

Private company issues

6. Private companies expressed the same concerns as those noted above. Additionally, one respondent noted that it would be difficult to distinguish between both of the following:

   (a) The types of costs that would be eligible for recognition as an asset under paragraph 58 of the ED (that is, as a resource to be used to satisfy performance obligations in the future); and

   (b) Other types of costs that would be recognized as expenses as incurred under paragraph 59 of the ED, including costs of obtaining a contract.

7. The following sections discuss each of the issues noted above and the staff's recommendations.

The proposed guidance is inconsistent with other existing accounting literature

8. Several preparers and auditors noted that the ED's proposed guidance on the costs of obtaining a contract is inconsistent with the cost guidance in the IASB's and the FASB's other existing literature, including IAS 2, *Inventories;* IAS 38, *Intangible Assets;* Topic 310, *Receivable;* Topic 360, *Property, Plant, and Equipment;* and the definition of an asset in the Boards' conceptual frameworks. Specifically, they noted that those standards require some costs of acquiring an asset to be capitalized (by including them in the measurement of the underlying asset).

9. Some of those respondents recommended that the ED use the guidance in those standards for capitalizing the costs of obtaining a contract. Other respondents suggested that the Boards develop comprehensive cost guidance that would be applicable across all accounting standards. Those respondents recommended adding a separate project on costs that would be finalized concurrently with any revenue recognition standard.

10. The staff notes that the Board decided to issue the ED to develop a revenue recognition model for contracts with customers that would improve accounting practices that are different for economically similar transactions as well as to enhance convergence. The Board did not intend to address all of the cost guidance in existing accounting literature in this project, only the guidance that would be affected by withdrawing existing revenue recognition guidance. Therefore, the staff recommends that the Board not comprehensively address the cost guidance in other existing accounting literature (including inventory and intangibles) at this time.

Question for the Board
1. Do the Boards agree that the revenue recognition project should not comprehensively address all cost guidance during redeliberations?

Cost guidance does not belong in a revenue recognition standard

11. Many respondents questioned why guidance on the costs of obtaining a contract was included in a standard on revenue recognition.

12. The staff notes that the Boards decided to include cost guidance in the ED because it provides guidance on contracts with customers, which includes both rights and performance obligations. Therefore, the staff believes it is necessary to address what is included and excluded from those rights and performance obligations in order to account for revenue from contracts with customers.

Some costs of obtaining a contract result in future benefits that represent an asset

13. Many respondents disagreed with recognizing all costs to obtain a contract as expenses as incurred because some costs give rise to assets and, therefore, should be capitalized. For example, respondents noted that some costs of obtaining a contract are recoverable from future cash flows, such as sales commissions paid upfront for a non-cancelable contract, or contract negotiation costs that are explicitly chargeable to the customer under the contract. Those respondents suggested a number of ways of

including guidance that would require some costs of obtaining a contract to be capitalized.

14. The staff agrees that in some cases costs from obtaining a contract result in the creation of an asset that should be recognized. As noted above, the ED acknowledges that, conceptually, the costs of obtaining a contract may result in the creation of an asset, that is, a contract asset (even though the ED precluded recognition of any such asset). Therefore, this issue is addressed further in paragraphs 21–32 of the Alternatives section of the paper.

The proposed guidance is inconsistent with other Exposure Drafts

15. Other respondents noted that the ED is inconsistent with the Exposure Drafts, *Insurance Contracts; Leases;* and *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* which have the effect of deferring the expense recognition of some acquisition costs rather than recognizing them in profit or loss when incurred. Those respondents recommended that the Boards develop a consistent methodology across all of these projects to improve consistency between economically similar transactions or to justify why there are inconsistencies.

16. The staff agrees that the ED's proposed guidance on costs of obtaining a contract is inconsistent with the proposed guidance in the Boards' other Exposure Drafts because those Exposure Drafts would require deferral of expense recognition for some acquisition costs. However, the staff thinks that there are significant differences between the Exposure Drafts on the level of specificity and in the definitions of which costs may be deferred (See Appendix A for the specific guidance on acquisition costs for each Exposure Draft).

17. For example, the staff thinks that some of the costs eligible for capitalization under the *direct loan origination costs* definition in the FASB's Financial Instruments Exposure Draft would not be eligible for deferral under the *incremental acquisition costs* and *initial direct costs* definitions in the Insurance Contracts and Leases

Exposure Drafts. While payroll taxes, dental and medical insurance, and group life insurance costs may be deferred as direct loan origination costs, they would likely need to be expensed as incurred under the definition of *incremental acquisition costs* because those costs would have been incurred even if the loan had not been originated.

18. While the IASB's Insurance Contracts and Financial Instruments Exposure Drafts, and the Boards' Leases Exposure Draft, are consistent in principle on which acquisition costs should be deferred (that is, they all include an incremental cost notion that defers expense recognition only if the costs would not have been incurred had the transaction or contract not been made), they differ in the examples provided as guidance for the principle (see Appendix A for the specific guidance in each Exposure Draft).

19. The staff agrees that, conceptually, the Boards' treatment of acquisition costs should be consistent across its various projects. However, the staff believes that each project has distinct objectives, as well as different accounting models that may justify different treatment of acquisition costs. For example, in the Leases Exposure Draft, the Boards considered recognizing initial direct costs as an expense when incurred, but rejected that approach because it would be inconsistent with the treatment of costs associated with acquiring property, plant, and equipment. The Boards concluded that it was more important to maintain consistency between assets that are leased and assets that are purchased than to be consistent with other projects.

20. Additionally, the staff believes that the revenue recognition model is different from the proposed insurance model, which is a contract measurement model. Therefore, the staff believes it would be difficult for the Boards to get a consistent accounting treatment in both projects for the recognition of assets arising from the acquisition of a contract and the related presentation of those assets.

Alternatives and staff recommendation

21. Due to the broad nature of what may be capitalized under the FASB's Financial Instruments Exposure Draft, and the significant number of examples required to provide clarity to the definitions, the staff rejected the direct cost notion as a potential alternative for the revenue recognition standard. The staff concluded that it would be very difficult to develop the examples necessary to provide guidance for a direct costs based definition that would achieve consistency for all of the different types of contracts that will be in the scope of the revenue recognition standard.

22. Having reviewed the possible approaches in the Boards' other Exposure Drafts and based on respondents' comments to the ED, the staff considered the following alternatives for recognizing assets as a result of originating a contract for the following types of costs :

    (a) The incremental costs of obtaining a contract that are expected to be recovered

    (b) Costs that are guaranteed to be recovered.

Alternative A – Incremental costs that are expected to be recovered

23. Alternative A would require an asset to be recognized for the incremental costs of obtaining a contract that are expected to be recovered. Incremental costs are those costs that are directly attributable to obtaining a contract that would not have been incurred if the contract had not been obtained.

24. Those costs of obtaining a contract that are recognized as an asset would be presented with the entity's contract assets. Additionally, the asset would be amortized on a systematic basis consistent with the pattern of transfer of the goods or services in the underlying contract with the customer.

Advantages of Alternative A

25. Alternative A would address the concerns of preparers and auditors who commented on the inconsistency with other Exposure Drafts and the anomalous effects that can arise from recognizing all costs of obtaining a contract as expenses as incurred. Specifically, it would be consistent with the Boards' decisions in the Insurance Contracts and Financial Instruments Exposure Drafts that incremental acquisition costs should not be recognized in profit or loss at contract inception, which would improve comparability for the costs incurred in acquiring a contract in similar transactions.

26. Alternative A also would be consistent with existing accounting literature and familiar to auditors and preparers. Alternative A would be consistent with decisions reached on transaction costs in IFRS 9, *Financial Instruments,* and the costs of securing the right to provide investment management services in IAS 18, *Revenue*. Additionally, Alternative A would be consistent with FASB Codification paragraph 605-20-25-4, which provides the following guidance for separately priced extended warranty and product maintenance costs:

    > Costs that are directly related to the acquisition of a contract that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) shall be deferred and charged to expense in proportion to the revenue recognized.

Disadvantages of Alternative A

27. Some believe that recognizing the costs of acquiring a contract as an asset in accordance with other areas of accounting literature (for example, the incremental costs of writing a loan) overstates those assets in many cases. For example, all of the acquisition costs incurred to write subprime loans that defaulted during the financial crisis turned out to be expenses on day 1 and overstated the carrying amount of the loans. Opponents of Alternative A believe that contract acquisition costs should be expensed as incurred because it is often difficult for management to determine whether those costs will be recovered through future cash flows.

Alternative B – Costs that are guaranteed to be recovered

28. Alternative B would require all costs of obtaining a contract to be recognized as expenses as incurred except those that are guaranteed to be recovered. Costs that are guaranteed to be recovered would include bid-and-ask costs that are specifically chargeable to the customer, regardless of whether the contract is obtained.

29. Costs that are guaranteed to be recovered would be presented and subsequently measured the same as Alternative A.

Advantages of Alternative B

30. Those who support Alternative B note that it would largely eliminate uncertainty about whether an incremental cost may be recovered through future cash flows. Only those costs incurred in obtaining a contract that are explicitly guaranteed to be recoverable would be recognized as an asset.

31. Supporters of Alternative B believe that costs of obtaining a contract do not have value just because an entity intends to recover those costs through future cash flows of the business. Supporters of Alternative B view costs of obtaining a contract as transaction costs, and see no difference between those costs and other costs that an entity expects to recover that are expensed as incurred, such as selling, general, and administrative expenses.

Disadvantages of Alternative B

32. Fewer costs of obtaining a contract would be deferred under Alternative B when compared to Alternative A. In many instances, this may lead to some costs of obtaining a contract being expensed when they are ultimately recoverable from future cash flows from the contract. Those instances are likely to occur in industries (for example, investment managers) in which significant commissions are paid up front to obtain a contract, and those commissions are recovered over time through future cash flows. Additionally, Alternative B would reduce consistency with the Boards' decisions in the other Exposure Drafts and existing standards.

Staff Recommendation

33. The majority of the staff recommends Alternative A, while one staff member recommends Alternative B. Alternative A is consistent with many of the Boards' other Exposure Drafts and existing accounting literature. Therefore, it would improve consistency and is familiar to preparers and auditors. Additionally, Alternative A would eliminate the distortion for high growth companies that incur a significant amount of costs to obtain contracts but in which revenue is recognized over future periods. In those cases, companies could report lower net income because much of the revenues to which the contracts relate are deferred to future periods, while all of the expenses for obtaining the contract would be recognized up front.

Questions for the Boards
2. Do the Boards agree with recognizing an asset for all incremental costs of obtaining a contract?

Appendix A

1. The following paragraphs summarize the guidance for the accounting of acquisition costs in the Insurance Contracts, Leases, and Financial Instruments Exposure Drafts.

Insurance contracts Exposure Draft

2. The Insurance Contracts Exposure Draft would require an insurer to include *incremental acquisition costs* in the present value of the fulfilment cash flows. That is, once those costs are incurred, they reduce the present value of the liability for fulfilment cash flows. All other acquisition costs would be expensed as incurred. *Incremental acquisition costs* are defined as follows:

> The costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.

3. The Insurance Contracts Exposure Draft further clarifies that these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.

Leases Exposure Draft

4. In the Leases Exposure Draft, *initial direct costs* are capitalized as part of the right-of-use asset (lessee) or the right to receive lease payments (lessor). *Initial direct costs* are defined as follows:

> Recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

5. The implementation guidance states that *initial direct costs* may include:

   (a) Commissions

   (b) Legal fees

(c) Evaluation of the prospective lessee's financial condition

(d) Evaluating and recording guarantees, collateral, and other security arrangements

(e) Negotiating lease terms

(f) Preparing and processing lease documents

(g) Closing the transaction

(h) Other costs that are incremental and directly attributable to negotiating and arranging the lease.

6. The implementation guidance also states that the following are not *initial direct costs:*

(a) General overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time.

(b) Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities.

Financial instruments Exposure Draft

7. The IASB's Financial Instruments Exposure Draft would require deferral of all *transaction costs,* which are defined as follows:

> Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

8. The FASB's Financial Instruments Exposure Draft would require deferral of *direct loan origination costs* (net of loan origination fees), which are defined as follows:

> Direct loan origination costs represent costs associated with successfully originating a loan. Direct loan origination costs of a completed loan shall include only the following:
>
> Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan

> Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
>
> Evaluating the prospective borrower's financial condition
>
> Evaluating and recording guarantees, collateral, and other security arrangements
>
> Negotiating loan terms
>
> Preparing and processing loan documents
>
> Closing the transaction.
>
> The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

9. The FASB's Financial Instruments Exposure Draft provides the following examples of other direct loan origination costs that may be deferred:

    (a) Reimbursement of costs for air travel, hotel accommodations, automobile mileage, a similar costs incurred by personnel relating to the specified activities

    (b) Costs of itemized long-distance telephone calls related to loan underwriting

    (c) Reimbursement for mileage and tolls to personnel involved in on-site reviews of collateral before the loan is granted.

10. It also provides the following examples of payroll related fringe benefits that may be deferred:

    (a) Payroll taxes

    (b) Dental and medical insurance

    (c) Group life insurance

    (d) Retirement plans

    (e) 401(k) plans

(f) Stock compensation plans, such as stock options and stock appreciation rights

(g) Overtime meal allowances.

11. The FASB's Financial Instruments Exposure Draft provides further guidance on executive compensation that may be deferred. It states that the amount of executive compensation allocable to time spent by members of a loan approval committee is a component of direct loan origination costs.

12. The FASB's Financial Instruments Exposure Draft provides further examples of specified activities contemplated as direct loan origination costs as follows:

    (a) Loan counselling, such as discussing alternative borrowing arrangements with borrowers, and negotiating terms

    (b) Application processing

    (c) Appraisal

    (d) Initial credit analysis

    (e) Initial credit investigation

    (f) Quality control review performed during the underwriting period

    (g) Direct approval processing

    (h) Loan evaluation and approval committees (all activities involved in origination decisions)

    (i) Loan closing.