Project	**Revenue recognition**
Topic	**Amortization and impairment**

Introduction and purpose

1. This paper considers improvements to the proposed guidance in the Exposure Draft, *Revenue from Contracts with Customers* (ED) on the amortization and impairment of an asset recognized from the costs incurred to fulfill a contract with a customer. The paper also considers amortization and impairment of an asset recognized from the costs to obtain a contract.

Staff recommendation

2. The staff recommends that for the impairment of an asset recognized from the costs of acquiring or fulfilling a contract with a customer:
   (a) an entity should recognize an impairment loss to the extent that the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is:
      (i) the amount of consideration the entity expects to receive in exchange for the goods or services to which the asset relates, less
      (ii) the costs that relate directly to providing those goods or services.
   (b) an entity should recognize a reversal of an impairment loss (and an increase in the carrying amount of the asset to its recoverable amount)

if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. The increased carrying amount of the asset should not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset previously.

3. For the amortization of an asset recognized from the costs of acquiring or fulfilling a contract with a customer, the staff recommends retaining the ED's amortization guidance, subject to a minor clarification that in some circumstances (e.g. set up costs for a renewable services contract), the asset might relate to goods or services beyond those that are promised in the initial contract.

Structure of paper

4. This paper is organized as follows:
    (a) Background information (paragraphs 5–9)
    (b) Staff analysis
        (i) Impairment model (paragraphs 10–14)
        (ii) Reversals of impairment losses (paragraphs 15–23)
        (iii) The amortization period (paragraphs 24–38)

Background information

5. The ED proposed that an entity should amortize an asset arising from fulfillment costs on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

6. The ED also proposed that an entity should recognize an impairment loss to the extent that the carrying amount of an asset arising from fulfillment costs exceeds the amount of the transaction price allocated to the remaining

performance obligations less the costs that relate directly to satisfying those performance obligations.

7. During redeliberations, the Boards decided to require an entity to recognize an asset arising from the incremental costs incurred to obtain a contract with a customer. Incremental costs are those costs that would not have been incurred if the contract had not been obtained (such as commissions paid to sales representatives for contracts acquired). The remainder of this paper includes that asset in the consideration of issues relating to amortization and impairment.

8. Most respondents to the ED were supportive of the proposed guidance on the costs of fulfilling a contract (including amortization and impairment), and concluded it was understandable and operational. Those who supported the proposed guidance noted that it would enhance convergence and improve on existing guidance that would be superseded by the ED.

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

   (a) The wording of the impairment model in the ED,

   (b) Reversals of impairment losses, and

   (c) The amortization period.

Staff analysis

Wording of the impairment model in the ED

10. Some respondents to the ED (in comment letters and through the staff's outreach efforts) highlighted a concern about the interaction between the wording of the impairment model in the ED and the Boards' decision that an entity should recognize an asset from some fulfillment costs that may be incurred before a contract is signed (i.e. precontract costs).

11. If a contract does not yet exist for purposes of applying the revenue model, then an entity would not have determined and allocated the transaction price to separate performance obligations. Consequently, strict application of the

wording of the impairment model in the ED would require, in theory, an entity to recognize an asset arising from some precontract costs and then to immediately recognize an impairment of that asset. The staff thinks that was not an intended consequence of the wording of the impairment model.

12. To address that unintended consequence, the staff recommends revising the wording of the impairment model in the ED (paragraph 63 of the ED) as follows:

> An entity shall recognize an impairment loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 57 exceeds (a) the amount of consideration the entity expects to receive in exchange for the goods or services to which the asset relates ~~the amount of the transaction price allocated to the remaining performance obligations~~ less (b) the costs that relate directly to ~~satisfying~~ providing those goods or services ~~performance obligations~~.

13. In addition, the staff also thinks that the amount to which an entity would compare the carrying amount of the asset should be described in the final standard as the "recoverable amount" of the asset. That drafting change would:

    (a) facilitate drafting of the final standard—it would not be necessary for the standard to repeat the formula (a) less (b) (as described in paragraph 13 of this paper) in every instance that the standard refers to the amount, and

    (b) correspond more clearly with the criteria for initial recognition of the asset (for example, the criterion that an entity must expect to "recover" the costs that relate directly to a contract and that generate resources that will be used in satisfying performance obligations in the future.)

14. To determine the recoverable amount of the asset, an entity would refer to the other principles in the final standard. For example, the amount the entity "expects to receive" in exchange for the goods or services would be determined consistently with techniques used to determine the transaction price. Similarly, the costs that relate directly to providing the goods or services are those costs described in the guidance for determining whether to recognize the costs as an asset.

Question 1: Impairment model
Do the Boards agree that an entity should recognize an impairment loss to the extent that the carrying amount of the asset recognized from costs to acquire or fulfill a contract exceeds its recoverable amount? The recoverable amount of the asset is: (a) the amount of consideration the entity expects to receive in exchange for the goods or services to which the asset relates, less (b) the costs that relate directly to providing those goods or services.

Reversals of impairment losses

15. Some respondents questioned whether it is appropriate to reverse impairment losses in accordance with the ED. One respondent noted the following:

> Further, we believe that an entity should be permitted to reverse an impairment loss similar to adjustments associated with onerous performance obligations and our understanding of the provisions of IAS 36, Impairment of Assets. The Proposal does not address whether an impairment loss on assets recognized in accordance with Paragraph 57 should be reversed if the conditions causing the impairment loss no longer exist. We recommend the Boards include guidance with respect to the accounting for reversals of impairment losses in the final standard to address convergence with IFRS. [Kodak]

16. As highlighted by respondents to the ED, the ED was not clear on whether an entity should recognize reversals of an impairment loss. The staff notes that existing guidance on impairment and amortization of PP&E, inventory, and intangibles is not the same in IFRSs and U.S. GAAP. The primary difference between existing impairment models in IFRS and U.S. GAAP relates to reversals of previous impairments. IAS 2, *Inventories* and IAS 36, *Impairment of Assets* require an entity to reverse previous impairments (limited to the original carrying amount prior to impairment) if specified criteria are met, while Topic 330 and Topic 360, Property, Plant, and Equipment, prohibit reversals of impairments. Appendix A summarizes those existing requirements.

Alternatives

17. The Boards have the following alternatives for clarifying whether an entity should recognize reversals of an impairment loss:

    (a) Alternative A: prohibiting reversals of impairments, and

    (b) Alternative B: requiring reversals of impairments.

18. Alternative A would be consistent with most existing impairment guidance in U.S. GAAP for inventory and PP&E. (However, the staff notes that in some circumstances under US GAAP, an entity reverses provisions for inventory obsolescence within a fiscal period.) Additionally, it would be less costly for preparers because they would not be required to reassess whether a prior impairment should be reversed.

19. However, Alternative A would be inconsistent with existing guidance in IFRSs that requires reversals of impairments of inventories, PP&E, and goodwill when there is an indication that an impairment no longer exists.

20. Alternative B would require an entity to recognize a reversal of an impairment loss (and an increase in the carrying amount of the asset to its recoverable amount) if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. Any subsequent reversal of an impairment loss would not exceed the carrying amount that would have been determined (net of amortization and depreciation) had no impairment loss been recognized for the asset previously.

21. Because the ED would require an entity to first impair the asset before recognizing an onerous liability, the standard similarly would clarify the interaction of the impairment reversal with the onerous liability. An entity first would reverse any onerous liability before increasing the carrying amount of the asset (to avoid 'grossing up' of the balance sheet).

22. Alternative B would be consistent with impairment guidance in IFRSs for inventories, PP&E, goodwill, and intangibles. Additionally, it would be consistent with the Boards' decision to require an entity to update the measurement of the liability for onerous performance obligations at each

reporting date, and recognize a reduction of an expense when the liability is reduced, or no longer onerous.

Staff recommendation

23. The staff recommends Alternative B, which would increase consistency with existing impairment guidance in IFRSs. The staff believes that Alternative B would provide better information about an entity's most recent and best estimates of the costs to fulfill a contract, and whether those costs will be recovered.

Question 2: Reversals of impairment losses
The staff recommends that an entity should recognize a reversal of an impairment loss (and an increase in the carrying amount of the asset to its recoverable amount) if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. The increased carrying amount of the asset should not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset previously. Do the Boards agree?

The amortization period

24. The ED included guidance requiring an asset arising from the costs incurred to fulfill a contract to be amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates.

25. Some respondents requested clarification of whether an asset arising from the costs of fulfilling a contract with a customer should be amortized based on goods or services transferred in an existing contract, or whether those goods or services could relate to more than one contract (and possibly future contracts).

26. One respondent noted the following:

> The amortization and impairment model for contract costs is not consistent with the model under other standards and we believe where an asset can be demonstrated to have an anticipated benefit related to future contracts (either with the same customer or different customers), the amortization should consider the period over which the asset is expected to

> contribute directly or indirectly to the future cash flows of the entity. It should not be limited in all cases to the duration of existing contracts. [Ernst & Young]

27. Because there were few respondents who commented on amortization, the staff spoke with additional preparers and auditors to determine whether others believe clarifying guidance is needed on this issue. Some of the preparers and auditors recommended clarifying in the final standard that the amortization period of the asset could extend beyond one contract in some circumstances.

28. One auditor highlighted existing guidance in Subtopic 605-10-S99 on amortizing setup costs associated with deferred revenue. That guidance requires an entity to amortize the costs over the same period that the deferred revenue is recognized as revenue. The auditor highlighted an example that is included in both the ED and in existing guidance in Subtopic 605-10-S99 on nonrefundable upfront fees that an entity charges a customer at or near contract inception. In that example, the entity charges the customer a non-refundable joining fee in part as compensation for the initial activities of registering the customer. The customer can renew the contract each year without paying the joining fee.

29. Both the ED and Subtopic 605-10-S99 state that the nonrefundable joining fee would be recognized as revenue during the period that the entity expects to provide services to the customer. Presumably, this would include the period over which the customer is expected to exercise options to renew the contract in future periods.

30. While Subtopic 605-10-S99 provides the same guidance for deferring the costs of setup activities for the contract, some thought that the ED was not clear on the appropriateness of that same accounting.

Staff analysis and recommendation

31. The ED was intentionally drafted to allow the possibility of an entity amortizing the asset over more than one contract. An entity would be required to use judgment when determining that pattern of transfer. That judgment would place emphasis on one of the core principles of the revenue standard based on the 'pattern of transfer of goods or services'.

32. The staff thinks the asset should be amortized over more than one contract when the asset is expected to be used to satisfy performance obligations in specific anticipated contracts. This is consistent with the Boards' decision to require an entity to recognize an asset for precontract costs if those costs are expected to be recovered from specific anticipated contracts.

33. Amortizing the asset over more than one contract (including future contracts) is consistent with existing requirements for PP&E and intangibles. For example, equipment of an entity could be used to satisfy performance obligations in many contracts and, hence, the total costs of the equipment should not be expensed during just the first contract.

34. Similarly with some intangibles used to satisfy performance obligations in contracts with customers, intellectual property recognized as an asset is not completely derecognized when the property is licensed in the first contract. Rather, it is amortized in accordance with the pattern of transfer of goods or services to which the asset relates.

35. For example, ASC 926-20-35-1 on the amortization of capitalized costs of producing a film requires an entity to amortize costs "in the same ratio that current period actual revenue (numerator) bears to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year (denominator)." Ultimate revenue includes estimates of future revenues up to a period of 10 years. IFRSs are not as specific on the period of estimated revenues required to determine the amortization of intangible assets such as capitalized costs of producing a film or TV episode. But the amortization period extends beyond the initial contract.

36. Hence, the staff recommends retaining the ED's amortization guidance subject to a minor clarification that in some circumstances, the asset might relate to goods or services in more than one (possibly future) contracts.

37. To make that clarification, the staff thinks the Boards could include in the final standard an illustration on setup costs that benefit more than one contract. The example could be similar to the following:

> An entity enters into a contract with a customer for one year of transaction-processing services. The entity charges the customer a non-refundable upfront fee in part as compensation for the initial activities of setting up the customer on the entity's systems and processes. The customer can renew the contract each year without paying the joining fee.
>
> The entity's set-up activities do not transfer any service to the customer and, hence, do not give rise to a performance obligation. Consequently, the entity would allocate the transaction price (including the non-refundable upfront fee) to the first year of services and to the customer's option to renew the contract and receive additional services without paying an additional upfront fee. Hence, the entity recognizes as revenue the upfront fee during the period that the entity expects to provide services to the customer.
>
> The setup costs that are incurred enhance resources of the entity that will be used in satisfying performance obligations in the future, and are expected to be recovered. Therefore, the entity would recognize an asset for the setup costs, which would be amortized over the period that the entity expects to provide services to the customer (consistently with the pattern of revenue recognition).

38. The outcome of the illustration above also is consistent with the ED's guidance on nonrefundable upfront fees in paragraph B28 of the ED.

Question for the Boards

Question 3: Amortization
Do the Boards agree with the staff's recommendation to retain the ED's amortization guidance subject to a minor clarification that in some circumstances (e.g. set up costs for a renewable services contract), the asset might relate to goods or services beyond those that are promised in the initial contract?

Appendix A Summary of existing requirements in US GAAP and IFRSs

	IAS 2, Inventories	Topic 330, Inventory	IAS 36/38, Impairment/Intangibles	Topic 360, Property, Plant, and Equipment	Topic 350, Intangibles
Subsequent Measurement	Recognized as an expense when sold in the period in which the related revenue is recognized based on FIFO formula or weighted average cost method.	Inventory costs are matched against revenue based on FIFO, average cost, and LIFO methods.	Finite life intangible assets – amortized on a systematic basis over their useful life	Depreciated over useful life of asset.	N/A – internally generated intangible assets are recognized as expenses when incurred.
Impairment	Inventories are impaired when the net realizable value is less than the cost of inventories.	Inventories impaired to lower of cost or market (meaning current replacement cost). Replacement cost shall not exceed the net realizable value, and shall not be less than net realizable value reduced by an allowance for a normal profit margin.	Asset is written down to recoverable amount, defined as the higher of the asset's fair value less costs to sell and its value in use, when that amount is less than the carrying amount.	Asset is written down to fair value if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.	N/A
Recoveries	Write downs to net realizable value may be reversed if inventory value subsequently increases, but the reversal is limited to the amount of original write-down.	Recoveries of previous write downs are not permitted.	Write downs to recoverable amount may be reversed, but the reversal is limited to the amount of the original write-down.	Recoveries of previous impairments are not permitted.	N/A