STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Contract costs		
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Purpose

1. This paper considers possible modifications and clarifications to the proposed requirements in paragraphs 91 – 103 of the Exposure Draft, *Revenue from Contracts with Customers* ('2011 ED'), relating to the accounting for contract acquisition and fulfillment costs.

Staff recommendation

2. The staff recommend that the Boards:

   (a) retain the proposal in the 2011 ED to recognize as an asset the incremental costs of obtaining a contract, but expand the practical expedient to apply regardless of the duration of the amortization period of the asset that would otherwise have been recognized. An entity would be required to apply the practical expedient consistently; and

   (b) require that, if an entity has elected to use the practical expedient, it should disclose that fact.

Structure of the paper

3. The remainder of this paper is organized into the following sections:

   (a) Background (paragraphs 4-7);

   (b) Proposed requirements in the 2011 ED (paragraphs 8-14);

   (c) Summary of respondent feedback (paragraphs 15-21);

   (d) Staff analysis (paragraphs 22-30);

   (e) Staff recommendation (paragraph 31).

   (f) Appendix A – Summary of proposed changes

Background

Fulfillment costs

4. The Basis for Conclusions in the 2011 ED states that fulfillment cost guidance is being included in the proposed revenue recognition standard to fill the gap arising from the withdrawal of existing revenue standards. Furthermore, by clarifying the accounting for some costs related to a revenue contract with a customer, the proposals should also improve current practice and promote greater convergence between US GAAP and IFRSs.

5. The proposals in the 2011 ED would apply only to a subset of fulfillment costs—specifically those costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic/IFRS (eg standards on inventory; property, plant and equipment; and intangible assets).

Acquisition costs

6. Current US GAAP allows entities to make a policy election to capitalize or expense the costs of acquiring a contract. The 2010 ED proposed to remove the policy election allowed in current US GAAP and require that all entities expense the costs of obtaining a contract. The staff received feedback on these proposals

from preparers in various industries, as well as auditors, standard setters, and users. This feedback is summarized in the 2011 ED's Basis for Conclusions (paragraph BC223), which states:

> Many respondents disagreed with recognizing all costs to obtain a contract as expenses when incurred because they thought that the assets arising from those costs should be recognized in some cases. In addition, they noted that:
>
> (a) Other standards require some of the costs of obtaining a contract to be included in the carrying amount of an asset on initial recognition.
>
> (b) The proposals in the 2010 proposed Update were inconsistent with the tentative conclusions in the Boards' leases and insurance contracts projects.

7. After considering the feedback received from respondents on the 2010 ED, the Boards reconsidered the proposed requirement to expense the costs of obtaining a contract.

Proposed requirements in the 2011 ED

8. The proposed requirements for contract costs are described in paragraphs 91 – 103 of the 2011 ED. The 2011 ED also includes two contract costs examples in paragraphs IG72/IE14 and IG73/IE15. The proposed requirements are separated into three sections:

    (a) costs to fulfill a contract (paragraphs 91 – 93 of the 2011 ED);

    (b) incremental costs of obtaining a contract (paragraphs 94 – 97 of the 2011 ED); and

    (c) amortization and impairment of assets arising from (a) and (b) (paragraphs 98 – 103 of the 2011 ED).

Fulfillment costs

9. Paragraph 91 of the 2011 ED states that an entity should recognize an asset from the costs to fulfill a contract only if those costs meet all of the following criteria:

   (a) the costs relate directly to the contract (or a specific anticipated contract);

   (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.

10. If the costs to fulfill a contract do not meet all of those criteria, an entity should recognize those costs as expenses when incurred. Paragraphs 92 and 93 of the 2011 ED provide additional guidance by listing various costs that relate directly to the contract and identifying costs that should be expensed when incurred.

Acquisition costs

11. An entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. Paragraph 95 of the 2011 ED defines incremental costs of obtaining a contract as costs that an entity incurs in its efforts to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (eg a sales commission). The Boards specified that costs must be 'incremental' in order to distinguish contract acquisition costs from other customer-related costs. For example, costs incurred to maintain relationships with existing customers in hopes of getting a contract renewal are not incremental because they would have been incurred regardless of whether the customer renews the contract.

12. The proposed requirements include a practical expedient that allows an entity to recognize incremental costs to obtain a contract as an expense if the amortization period of the asset would have been one year or less. The practical expedient was included because the Boards acknowledged that, in some cases, the costs to an

entity of recognizing an asset from incremental acquisition costs might exceed the financial reporting benefits.

Amortization and impairment

13. If an entity recognizes an asset from the costs to obtain or fulfill a contract, the entity should amortize the asset on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

14. An entity should recognize an impairment loss if the carrying amount of the asset exceeds the recoverable amount of the asset. The recoverable amount of the asset equals the remaining consideration the entity expects to be entitled for the asset less the costs that relate directly to providing the goods or services.

Summary of respondent feedback

15. Although the Boards did not specifically ask a question on the proposed requirements for contract costs, many respondents commented on the proposals, including preparers from the telecommunications, technology, and software industries.

16. The specific feedback from those respondents concentrated on the mandatory capitalization of incremental contract acquisition costs.

17. Many respondents from the telecommunications industry expressed concerns about the proposals for contract acquisition costs because they thought the proposals would diminish the comparability between sales from the direct channel (ie the entity's own stores) and from the indirect channel (ie third-party dealers). This issue, along with related allocation issues, are discussed comprehensively in paper 7C/165C on bundled arrangements.

18. Respondents from the technology and software industries have differing views on the proposals. Some respondents support the proposed requirements in the 2011 ED, especially for long-term contracts whereby an entity pays substantial sales

commissions. Many respondents support capitalization because the commissions paid are so closely related to the revenue from the customer contracts.

> Moreover, with the continued growth of the Cloud computing industry, which BMC and a growing number of technology companies participate in via [Software as a Service] and other subscription offerings whose revenues are generally recognized over non-cancelable contract service periods of one or more years, we believe that it is particularly important to maintain an asset recognition model for contract costs in order to properly reflect the true economics of transactions period to period and avoid the volatile distortion that would otherwise occur in financial statements. (CL#55 BMC Software, Inc)

19. In contrast, other respondents from the technology and software industries disagree with the proposed requirements to require the capitalization of contract acquisition costs, mainly because of the practical challenges involved. Respondents noted that it can be difficult to determine when a commission payment is incremental to obtaining a new customer contract.

> We do not agree with the requirement in the revised ED to capitalize and recognize as an asset the incremental costs of obtaining a contract, such as sales commissions. In the case of sales commissions, it can be difficult to determine when a commission payment is incremental to obtaining a new customer contract, expanding sales into an existing customer account, fulfilling the deliverables in the contract or managing the client relationship … It is likely that companies will have different interpretations of what they define as an incremental cost of obtaining a contract. (CL#26 International Business Machines)

21. Respondents also cited the costs associated with systems that will be needed to make a continuous assessment of impairment and amortization periods. These respondents suggested that, similar to current US GAAP, the Boards should

permit an entity to make an accounting policy election about whether to capitalize or expense acquisition costs. Some of those respondents suggested that an entity should make that choice after assessing which approach would be the most appropriate for their business.

> Enabling policy elections will make the ASU applicable across multiple industries and allow a business to decide how and whether the contract costs are meaningful to their business. Tracking the costs to be compliant with the standard would be burdensome and in most cases would not result in a benefit to investors. Any policy elections should be disclosed in the financial statements to allow investors to understand the treatment of contract costs. This will allow companies the ability to track costs as applicable to their business. At Dell tracking all the incremental costs associated with obtaining a contract would require additional system and personnel tracking the costs given the number of contracts that would qualify under this requirement. (CL#85 Dell)

Staff analysis

22. The staff think there are three alternatives to accounting for contract acquisition costs to address concerns raised by constituents:

    View A - retain the proposals in the 2011 ED (including the one-year practical expedient);

    View B - require expensing of all contract acquisition costs; or

    View C – retain the proposals in the 2011 ED, but expand the practical expedient.

23. The staff considered a fourth alternative, which would have required contract acquisition costs to be capitalized unless specified criteria were met. However, the staff struggled to develop criteria and think this alternative would have been

difficult to apply, thereby making the model more complex. As such, the staff think it would not be a viable alternative.

View A – retain the proposals in the 2011 ED (including the one-year practical expedient)

24. The advantages of capitalizing contract acquisition costs are as follows:

    (a) In some cases, it might be misleading for an entity to recognize all the costs of obtaining a contract as expenses when incurred. For example, in a long-term service arrangement, it is a better reflection of the economics of the transaction to recognize an asset (in concept, a contract asset), particularly if the asset represents a material portion of the contract's profitability. For example, consider a high-growth entity that primarily enters into two-year service arrangements. The entity pays commissions that are equivalent to the first two months of revenue. If the entity expensed the commissions as incurred, it would record an operating loss for each new customer in the period the contract is signed. In other words, the more successful the entity is in obtaining new customer contracts, the worse its operating income. Furthermore, constituents have expressed a reluctance to provide non-GAAP measures that back out cash operating expenses.

    (b) It would be consistent with the tentative decisions to date in the leasing, insurance, and financial instruments projects, as well as ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*.

    (c) Acquisition costs otherwise required to be capitalized would still be eligible for expensing under the practical expedient in situations where the amortization period would be one year or less.

View B – require expensing of all contract acquisition costs

25. The advantages of expensing all contract acquisition costs when incurred are as follows:

    (a) It would be easier to apply. Entities would not be required to distinguish between incremental costs of obtaining a contract and other customer-related costs.

    (b) It would be less costly. It would eliminate the need to implement new systems capable of tracking the costs and assessing the assets for impairment and the appropriate amortization period. Consequently, an entity would not be required to make the judgment about whether it was appropriate to apply the practical expedient when it did not anticipate a customer renewal.

View C – retain the proposals in the 2011 ED but expand the practical expedient

26. The primary concern with capitalizing acquisition costs is that, in some cases, the preparation costs associated with recognizing the asset could outweigh the financial reporting benefits. Along with that, commission expense may not be a significant metric in some industries or for mature companies.

27. The practical expedient in the 2011 ED would allow an entity to recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity would have otherwise recognized is one year or less. View C would not limit the practical expedient to one year. An entity could elect to apply the practical expedient to recognize the incremental costs of obtaining a contract as an expense when incurred regardless of the duration of the amortization period of the asset that would otherwise have been recognized.

28. This alternative acknowledges that conceptually the costs of obtaining a contract give rise to an asset. However, as a practical expedient, an entity could elect not to recognize the assets associated with obtaining a contract and instead recognize

the costs as expenses when incurred. The staff think that this alternative should be applied consistently and, if the entity elects to use the practical expedient, it should disclose that fact.

29. This alternative is similar to current US GAAP, which allows entities to elect to consistently either expense direct incremental acquisition costs or capitalize by analogy to Subtopic 310-20 (SFAS No. 91) or Section 605-20-25 (FTB 90-1). This alternative is accepted by the SEC and is codified at ASC 605-10-S99, SEC Topic 13.

30. The disadvantage of expanding the practical expedient is that it would not reduce any diversity that currently exists in accounting for those costs among comparable companies. However, the staff expect that entities in similar industries that have contracts with similar commission structures would probably account for the acquisition costs consistently, both to ensure that they are comparable with their peers and because they probably face similar systems issues. Although the application of the practical expedient would be disclosed, another disadvantage of expanding the practical expedient is that users would need to understand the entity's policy and adjust their analysis of the entity's financial statements accordingly.

Staff recommendation

31. The staff recommend View C, which would retain the proposals in the 2011 ED, but expand the practical expedient to apply regardless of the duration of the amortization period of the asset that would otherwise have been recognized. The staff note that entities would be required to apply the practical expedient consistently (ie entities would not be allowed to capitalize contract acquisition costs in one year and expense the costs in a subsequent year). If the Boards agree with the alternative, the staff recommend that, if the entity elects to use the practical expedient, it should disclose that fact.

Question – Accounting for contract acquisition costs

Do the Boards agree with the staff's recommendation to:

(a) retain the proposal in the 2011 ED to recognize as an asset the incremental costs of obtaining a contract, but expand the practical expedient to apply regardless of the duration of the amortization period of the asset that would otherwise have been recognized. An entity would be required to apply the practical expedient consistently; and

(b) require that, if an entity has elected to use the practical expedient, it should disclose that fact.

If not, which alternative would the Boards prefer for accounting for contract acquisition costs?

Appendix A

A1. The following table lists the proposed requirements from the 2011 Exposure Draft that relate to accounting for contract costs and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	Anticipated change?
Contract costs	
Costs to fulfill a contract (see paragraph 72)	
91 **If the costs incurred in fulfilling a contract with a customer are in the scope of another Topic (for example, Topic 330 on inventory, Topic 360 on property, plant, and equipment, or Topic 985 on software), an entity shall account for those costs in accordance with those other Topics. Otherwise, an entity shall recognize an asset from the costs to fulfill a contract only if those costs meet all of the following criteria:** (a) **The costs relate directly to a contract (or a specific anticipated contract).** (b) **The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.** (c) **The costs are expected to be recovered.**	No material change is anticipated.
92 Costs that relate directly to a contract (or a specific anticipated contract) include the following: (a) Direct labor (for example, salaries and wages of employees who provide services directly to the customer) (b) Direct materials (for example, supplies used in providing services to the customer) (c) Allocation of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract) (d) Costs that are explicitly chargeable to the customer under the contract (e) Other costs that are incurred only because the entity entered into the contract (for example, payments to subcontractors).	No material change is anticipated.
93 An entity shall recognize the following costs as expenses when incurred: (a) General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract,	No material change is anticipated.

in which case an entity shall evaluate those costs in accordance with the criteria in paragraph 91) (b) Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract (c) Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance) (d) Costs that relate to remaining performance obligations but that the entity cannot distinguish from costs that relate to satisfied performance obligations.	
Incremental costs of obtaining a contract	
94 **An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs, subject to the practical expedient in paragraph 97.**	No material change is anticipated.
95 The incremental costs of obtaining a contract are those costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission).	No material change is anticipated.
96 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.	No material change is anticipated.
97 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.	Staff recommend expanding the practical expedient – refer to paragraph 31 of this paper.
Amortization and impairment (see paragraph IG73)	
98 An asset recognized in accordance with paragraph 91 or 94 shall be amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under an anticipated contract that the entity can identify specifically (for example, services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).	No material change is anticipated.
99 An entity shall update the amortization to reflect a significant change in the entity's expected pattern of transfer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance	No material change is anticipated.

with Subtopic 250-10.	
100 An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 91 or 94 exceeds: (a) The remaining amount of consideration to which an entity expects to be entitled 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 (as described in paragraph 92).	No material change is anticipated.
101 To determine the amount to which an entity expects to be entitled, an entity shall use the principles for determining the transaction price.	No material change is anticipated.
102 Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 91 or 94, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic (for example, Topic 330), except for impairment losses of asset groups recognized in accordance with Topic 360 on property, plant, and equipment, and impairments of goodwill and intangible assets recognized in accordance with Topic 350 on goodwill and other intangibles.	No material change is anticipated.
103 **(FASB)** An entity shall not recognize a reversal of an impairment loss previously recognized. **(IASB)** An entity shall recognise in profit or loss a reversal of an impairment loss previously recognised when the impairment conditions cease to exist. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) had no impairment loss been recognised previously.	No material change is anticipated.