# STAFF PAPER

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| **Project** | **FASB-IASB Joint Transition Resource Group for Revenue Recognition** |
| Paper topic | Incremental costs of obtaining a contract |


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## Purpose

1. Some stakeholders informed the staff that there are different interpretations of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the 'new revenue standard'), regarding recognition of the incremental costs of obtaining a contract for capitalization and determining the period of amortization. The questions have arisen on commission arrangements, but the principles apply to other incremental costs of obtaining a contract. This paper summarizes the potential implementation issues reported to the staff.

## Background

2. Entities often pay sales commissions in respect of obtaining a contract. Determining the incremental cost is straightforward where the commission is a fixed amount or a percentage of contract value on a contract that is not expected to be renewed. However, more complex arrangements might require the exercise of judgement in applying the principles of the new revenue standard. Examples that some stakeholders have highlighted include commissions payable upon renewal of a contract, modifications to a contract, and sales commissions that are

contingent in some way or subject to a cumulative threshold (the staff have included several specific fact patterns below).

3. This paper discusses the accounting for commissions at the contract level. The staff think it is important for stakeholders to remember that the new revenue standard already includes two practical expedients that might be helpful when accounting for commissions.

    (a) Per paragraph 340-40-25-4 [94], 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.

    (b) Per paragraph 606-10-10-4 [4], an entity might take advantage of the practical expedient to account for the incremental costs of obtaining a contract at a portfolio level (for example, in determining an amortization period). An entity's specific facts and circumstances will dictate whether it can apply the guidance at a portfolio level.

## Accounting Guidance

4. The new revenue standard requires an entity to recognize as an asset the *incremental* costs of obtaining a contract with a customer if the entity expects to recover those costs. The asset is amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

5. The specific provisions in the new revenue standard and the Basis for Conclusions to the new revenue standard regarding the recognition of the incremental costs of obtaining a contract and determining the period of amortization are set out in Appendix A.

6. At the July 18, 2014 TRG meeting, the staff discussed a question about the impairment test for capitalized contract costs. A summary of that question is included in TRG agenda ref papers 4 and 5 (which were previously distributed to

the TRG members prior to that meeting and are available on the TRG website of each Board).

## Potential implementation issues

7. Some of the practical issues and different interpretations that have been brought to the staff's attention are explained below.

### *Commission paid on renewals after the initial contract is obtained*

#### *Issue 1a: Capitalization of the commission*

8. The first issue arises when a commission plan provides an employee with a commission for each contract obtained with a customer, as well as an additional commission each time that same customer renews the contract. In those circumstances, some have questioned what amount should be capitalized. Consider the following example:

> Example 1
>
> A sales employee is paid a commission for each contract obtained with a customer – CU100 is paid for a new customer contract.[1] CU60 is paid each time that same customer renews the contract. Assume the CU60 renewal commission is not considered commensurate with the CU100 commission paid on the initial contract.
>
> *View A* – Capitalize the CU100 paid for the new customer contract at contract inception. Capitalize the CU60 for each renewal upon renewal because it is considered an incremental cost that would not have been incurred if the renewal contract was not obtained.
>
> *View B* – Anticipate the number of renewals and capitalize the total anticipated commission amount (CU100 + (CU60 x number of anticipated renewals)) at contract inception.
>
> *View C* – Capitalize the CU100 paid for the new customer contract at contract inception. Do not capitalize the CU60 for each renewal because the CU60 is

[1] 'CU' represents currency units

not a cost to obtain the initial contract with the customer. It is a cost to obtain a renewal.

9. It would appear that only View A is in accordance with the new revenue standard.

10. With respect to View B, paragraph 340-40-25-2 [92] is clear that the incremental costs of obtaining a contract must relate to that contract.[2]

> "The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained."

11. At contract inception, the contract has not yet been renewed and any commission in respect of the renewal cannot be in respect of the initial contract.

12. With respect to View C, a renewal contract *is* a contract, there is nothing in paragraphs 340-40-25-1 [91] and 25-2 [92] to suggest a different treatment for contracts that are renewals of existing contracts. The staff note, however, that a contract extension may be considered a contract modification, rather than a new contract, if the consideration for the extension does not reflect the entity's standalone selling price for the additional goods or services. Issue 2 addresses the accounting for incremental costs from modifying an existing contract.

### *Issue 1b: What is the amortization period?*

13. The views to this question might depend on the view taken for capitalization of the commission in the question above. Consider the same facts as in Example 1 (this is a continuation of that example):

> Example 1 (continued)
>
> *View A* – Amortize the CU100 paid for the new customer contract over the original contract term. Amortize each capitalized renewal amount over the respective renewal period.
>
> *View B* – Amortize the total of the initial CU100 commission and the CU60 anticipated renewal commissions capitalized over the contract period that

[2] IFRS 15 references are included as '[XX]' throughout this paper.

includes the specific anticipated renewals (**note**: this view is only possible if one applies View B with respect to capitalization above).

*View C* – Amortize the initial amount capitalized over the contract period that includes the specific anticipated renewals (that is, over the expected customer relationship). Amortize each capitalized renewal amount over the respective renewal period.

*View D* – Separate the amortization of the CU100 capitalized into two components: amortize CU60 over the original contract term and CU40 over the period of the initial contract and the specific anticipated renewals. Upon renewal, capitalize CU60 and amortize it over the renewal period.

14. The overriding principle for amortization of contract cost assets in the new revenue standard is set out in paragraph 340-40-35-1 [99].

> "An asset recognized in accordance with paragraph 340-40-25-1 [91] or 340-40-25-5 [95] shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates."

15. BC309 further states:

> "…the Boards clarified that in amortizing the asset in accordance with the transfer of goods or services to which the asset relates, those goods or services could be provided under a specifically anticipated (that is, future) contract."

16. View A would be appropriate if the renewal contract is not a specifically anticipated future contract. Note that View A would also be appropriate if the renewal commission were to be considered commensurate with the initial commission, see Issue 1c.

17. View B is not appropriate because, as noted in Example 1, it is not appropriate to capitalize costs in respect of the anticipated renewal at the inception of the initial contract.

18. It therefore appears that, except in the limited circumstances discussed above under which View A would be appropriate, Views C and D are the alternatives that achieve the objective in accordance with 340-40-35-1 [99]. The staff think

that either alternative might be acceptable based on the guidance in the new revenue standard, if applied consistently to similar circumstances. Similar to current U.S. GAAP and IFRS, an entity will need to consider its individual facts and circumstances to make judgements about the amortization pattern and period for capitalized contract costs.

*Issue 1c: How should entities evaluate whether a commission paid for a renewal is "commensurate with" a commission paid on the initial contract (when determining the appropriate amortization period for an initial commission)?*

19. Paragraph 340-40-35-1 [99] states that:

> "An asset recognized in accordance with paragraph 340-40-25-1 [91] or 340-40-25-5 [95] shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a) [95(a)]."

20. The Boards clarified in the Basis for Conclusions (BC309) that:

> "However, amortizing an asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract."

21. The discussion in the Basis for Conclusions is helpful in some scenarios (for example, if the commission paid upon renewal is similar in amount to the initial commission paid). However, questions have arisen about how an entity should interpret the phrase "commensurate with" when determining the appropriate amortization period (for example, when a commission is paid for renewals, but at an amount less than the initial commission).

22. The Oxford English Dictionary defines "commensurate" as: "corresponding in size or degree, in proportion" giving the examples "salary will be commensurate

with age and experience" and "such heavy responsibility will receive commensurate reward."

23. The staff think that, in general, it would be reasonable for an entity to conclude that a renewal commission is "commensurate with" an initial commission if the two commissions are reasonably proportional to the respective contract value (for example, 5% of the contract value is paid for both the initial and the renewal contract). Similarly, the staff think it would be reasonable for an entity to conclude that a renewal commission is *not* "commensurate with" an initial commission if it is disproportionate to the initial commission (for example, 2% renewal commission as compared to a 6% initial contract commission). The staff do not think entities should have to undertake complex analyses to demonstrate a proportional renewal commission is "commensurate with" an initial commission *or* to demonstrate that a disproportionate renewal commission is not "commensurate with" an initial contract commission.

24. However, in practice, it is not unusual for it to be no more difficult to obtain a renewal than it is to secure the initial contract, or it might be *less* difficult as the incumbent of a contract to secure a renewal (for example, if there are barriers to the customer changing supplier or it is costly or difficult to establish new customer relationships). Accordingly, in some circumstances, if the renewal commission is less than the initial commission, it might still be "commensurate with" the initial commission. This will depend on the specific facts and circumstances and, therefore, judgement might be required.

### *Commissions on contract modifications*

*Issue 2: Should commissions earned on contract modifications that are not treated as separate contracts be capitalized?*

25. Consider the following example:

> Example 2
>
> An employee receives an initial commission based on the contract price when the contract is obtained. This commission is considered incremental, so it is capitalized under the new revenue standard.
>
> Subsequently, the customer modifies the contract to purchase additional goods, and the modification does not result in the company accounting for the modification as a separate contract in accordance with paragraph 606-10-25-12 [20]. Based on the company's policy, the employee is paid an additional commission based on the increase in the contract price from the modification. Should this additional commission be capitalized considering the contract already existed and the commission is not a cost to obtain a new contract?
>
> *View A* – No, the contract modification is not accounted for as a separate contract. Therefore, the additional commission paid is not an incremental cost of obtaining a contract and should be expensed.
>
> *View B* – Yes, even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in a cost (that is, the commission) that is incremental to obtaining the modified contract. Therefore, the additional commission paid is an incremental cost of obtaining a contract and should be capitalized.

26. If the entity does not account for the contract modification as a separate contract in accordance with paragraph 606-10-25-12 [20], then it is accounted for in one of two alternative ways depending on the facts and circumstances:

    (a) Firstly, it may be accounted for it as if it were "a termination of the existing contract and the creation of a new contract" under 606-10-25-13(a) [21a]. In this case the additional commission is an incremental cost of obtaining the new contract and should be capitalized in accordance with View B.

(b) Secondly, it may be accounted for as if it were a part of the existing contract under 606-10-25-13(b) [21b]. Paragraph 340-40-25-1 [91] refers to the "incremental costs of obtaining a contract," not to the *initial* incremental costs of obtaining a contract. It would appear, therefore, that an additional commission paid on a contract that is accounted for as part of the existing contract should be capitalized.

27. Therefore, View B is appropriate in either case.

### *Commission payments that are contingent on future events*

*Issue 3: Are the costs incremental if they are contingent on future events?*

28. Consider the following example:

> Example 3
>
> A commission is paid in installments over a period of time (for example, 1/4 of the total commission is paid every six months), but the payments cease if the customer fails to perform. Would the commissions scheduled to be paid after contract inception be considered costs to obtain the contract?
>
> *View A* – No, only the initial payment (1/4 of the total commission) should be capitalized as an incremental cost of obtaining a contract.
>
> *View B* – The total commission from the contract (that is, the initial and each of the subsequent payments) should be capitalized at contract inception. If the customer fails to perform, any unamortized capitalized costs would be considered for impairment.
>
> *View C* – The initial and each of the subsequent payments should be capitalized once payment occurs (or is due to be paid), assuming the customer continues to perform. If the customer fails to perform, any payments that have not yet been made should not be capitalized.

29. If the contract qualifies for recognition under the new revenue standard under 606-10-25-1 [9] (that is, it "passes" Step 1 – identify the contract with the customer), then the entity must have already concluded that the parties to the contract are "committed to perform their respective obligations" (paragraph 606-10-25-1a [9a]). Therefore, the entity should capitalize its incremental costs of obtaining the contract based on that conclusion. The fact that the payment of the

earned commission will occur over time does not affect whether the full commission is capitalised upon obtaining the contract. If circumstances subsequently change, such that there is doubt about whether the customer will perform its future obligations, then the entity would both (i) reassess whether there is a valid contract between the parties and (ii) assess the contract cost asset for impairment in accordance with paragraph 340-40-35-3 [101]. The staff note that it is important to remember that contract cost asset impairment is assessed against amounts the entity expects to *receive* in exchange for the goods or services to which the contract cost asset relates.

30. Therefore, View B is appropriate.

### *Commission payments subject to clawback*

*Issue 4: Should commission payments subject to clawback (that is, repayment to the entity if the customer does not perform) be capitalized as an incremental cost of obtaining a contract?*

31. Similar to Issue 3, if the contract qualifies for recognition under the new revenue standard under 606-10-25-1 [9] (that is, it "passes" Step 1 – identify the contract with the customer), then the entity must have already concluded that the parties to the contract are "committed to perform their respective obligations" and the entity should capitalise the commission payments. If circumstances subsequently change such that there is doubt about whether the customer will perform its future obligations, then the entity would both (i) reassess whether there is a valid contract between the parties and (ii) assess the contract cost asset for impairment.

### *Commission payments subject to a threshold*

*Issue 5: Should commissions based on achieving cumulative targets be capitalized?*

32. Commission plans for initial contracts and contract renewals for a specific employee might be established such that the commission is subject to a cumulative contract threshold. For instance, fixed or percentage commissions may commence or change once a specified threshold is achieved for the

cumulative number or value of contracts. Some stakeholders have raised questions about how and whether commissions for those types of plans should be capitalized.

33. BC302 states:

> "The Boards noted that it might be difficult for some entities to determine whether a commission payment is incremental to obtaining a new contract (for example, payment of a commission might depend on the entity successfully acquiring several contracts)."

34. This discussion was not intended to preclude entities from capitalizing costs that are payable on achieving cumulative targets because that discussion in BC302 is in the context of explaining that the Boards considered whether to allow an accounting policy election for contract costs under which an entity would have been able to choose to recognize an asset from the contract acquisition costs or recognize those costs as an expense.

35. The following examples illustrate various cumulative threshold scenarios that stakeholders have outlined to the staff. For purposes of this discussion, the staff have assumed the practical expedient for contract costs with an expected amortization period of one year or less does not apply.

36. In Example 4, once a cumulative threshold number of contracts is reached, commission is paid on individual contracts as a percentage of the value of *each* contract.

| Example 4 |
|---|
| 1-5 contracts ………..…………………0% commission |
| 6-10 contracts…………………………3% of individual contract price |
| 11+ contracts…...……………………...5% of individual contract price |

37. In Example 5, once a cumulative threshold value of contracts is reached, commission is paid on individual contracts as a percentage of the value of *each* contract.

| |
|---|
| Example 5 |
| First CU1 million contracts.... ………..0% commission |
| Next CU4 million contracts.... ………..3% of individual contract price |
| More than CU5 million contracts……. 5% of individual contract price |

*View A* – The particular contracts giving rise to commission are determined by reference to the cumulative value of all contracts; therefore, no particular contract results in an incremental cost of obtaining that contract and the commission paid is not directly attributable to any specific contract. Accordingly, no amounts should be capitalized.

*View B* – When the contract taking the aggregate value over CU1 million is signed, 3% of the contract price of that and successive contracts should be capitalized as an incremental cost of obtaining a contract until the CU5 million aggregate value is reached, when 5% of the contract price of that and successive contracts should be capitalized.

*View C* – The entity should estimate the total amount of commission to be earned for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract.

38. Paragraph 340-40-25-2 [92] states:

> "The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission)."

39. With respect to View A, all of the contracts that take the cumulative number/value of contracts above 5 contracts/CU1 million satisfy the criterion in paragraph 340-40-25-2 [92]; therefore, it does not appear appropriate to exclude commissions on those contracts from capitalization.

40. The staff think that either View B or View C could be acceptable based on the guidance in the new revenue standard.

41. The staff think that if an entity accrues commission amounts it expects to pay because they are probable and estimable (U.S. GAAP) [the entity has a present obligation and it is reliably estimable (IFRS)], then View C may be appropriate. This is because to recognize expense as the amount is accrued (Dr. Expense, Cr. Accrued Commission) during the period (and potentially across reporting periods) only to then *reverse* that expense in the period in which the commission is paid (Dr. Contract Cost Asset, Cr. Expense) might not produce representationally faithful results.

42. The staff think View C is consistent with the guidance in the new revenue standard (paragraphs 340-40-25-1 and 25-2 [91 and 92]). The costs that are being accrued and capitalized (if recoverable) are incremental to obtaining the contract that triggers the accrual and would not have been accrued had the contract not been obtained.

43. The staff think it would also be reasonable to apply View B. The words in paragraph 340-40-25-2 [92], as applied to this and the previous example, could reasonably be read to say that the 3% commission earned on contract 6 or on the contract that takes the salesperson's sales total above CU 4 million is incremental to obtaining *that* contract and was not payable until that contract was obtained.

44. In Example 6, once a cumulative threshold number of contracts is reached, commission is paid on that contract as a percentage of the *cumulative value of that contract and the preceding contracts*, taking into account any commission already paid.

| |
|---|
| Example 6<br><br>1-5 contracts ......................... 0% commission<br><br>6-10 contracts ....................... 3% of value of contracts 1-6<br><br>11+ contracts ........................ 5% of value of contracts 1-11<br><br>(including commission already paid for contracts 6-10)<br><br>*View A* – Because each contract does not result in an incremental cost of obtaining a contract and the commission paid is not directly attributable to a specific contract, no amounts should be capitalized.<br><br>*View B* – When contract 6 is signed, 3% of the cumulative prices of contracts 1-6 should be capitalized as an incremental cost of obtaining contract 6.<br><br>*View C* – The entity should estimate the total amount of commission to be paid for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract. |

45. With respect to View A, contracts 6 and 11 satisfy the criterion in 340-40-25-2 [92]. While the aggregate contract balance is used to calculate the commission, it is only paid when contracts 6 and 11 are obtained. Therefore, View A would not appear to be a reasonable application of the guidance.

46. Consistent with Examples 4 and 5 above, the staff think either View B or View C could be acceptable based on the guidance in the new revenue standard. The staff's rationale for this conclusion is consistent with the rationale outlined in the discussion of those previous examples.

47. The entity would then need to assess whether the commission is recoverable and the appropriate pattern of amortization.

48. Paragraph 340-40-35-1 [99] states:

> "An asset recognized in accordance with paragraph 340-40-25-1 [91] or 340-40-25-5 [95] shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates."

49. If the entity applies View C, the entity would amortize the commission accrued for each contract in accordance with paragraph 340-40-35-1 and 35-2 [99 and 100].

50. If the entity applies View B in Example 6, the entity might determine that the commission that only became payable upon obtaining contract 6 relates to the goods and services in contracts 1-6 and the commission payable on contract 11 relates to the goods and services in contracts 1-11. To do otherwise might result in counterintuitive accounting results if, for example, the commission paid upon obtaining contract 6 was large in relation to the transaction price for only contract 6. Allocating the entire commission paid upon obtaining contract 6 to only that contract might result in a margin that is not representative of the economics of the arrangement either for contract 6 or for the other contracts to which none of the commission was allocated.

51. Example 7, paying a lump-sum commission effectively in advance (after the *first* contract is obtained), has been provided to further illustrate the concepts discussed earlier in this Issue. In this example, the first commission is paid when the first contract is signed and subsequently, once a cumulative threshold number of contracts is reached, commission is paid on that threshold contract as a fixed escalating amount, taking into account any commission already paid.

Example 7

1 contract .............................. CU3,000 commission

10 contracts .......................... CU5,000 cumulative commission (including CU3,000 already paid)

15 contracts .......................... CU10,000 cumulative commission (including CU5,000 already paid)

Assume 11 new contracts are signed by a specific employee in the period.

> *View A* – Because each contract does not result in an incremental cost of obtaining a contract, no amounts should be capitalized.
>
> *View B* – Once the first contract is signed, CU3,000 should be capitalized as an incremental cost of obtaining the contract. No additional amounts are capitalized upon signing contracts 2-9 because the next commission "tier" has not been met. Once the tenth contract is signed, an additional CU2,000 should be capitalized.
>
> *View C* – The entity should estimate the total amount of commission to be paid for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract. In this example, if the entity estimates 11 contracts will be signed, the entity would capitalize CU455 when each contract is signed (CU5,000, divided by the 11 contracts signed equals CU455 to be capitalized as the commission amount per contract).

52. With respect to View A, the first and tenth contracts satisfy the criterion in paragraph 340-40-25-2 [92] and, therefore, it does not appear appropriate to expense the payments of CU3,000 and CU2,000.

53. Consistent with Examples 4 through 6 above, the staff think either View B or View C could be acceptable based on the guidance in the new revenue standard. The staff's rationale for this conclusion is broadly consistent with the rationale outlined in the discussion of Examples 4 through 6 This example differs, however, from Examples 4 through 6 because, after contract 1 is executed, the entity would be required to accrue the CU3,000 it contractually owes the salesperson (under either View B or C). Under View C, the entity would recognize a contract cost asset of CU455 (assuming 11 contracts will be obtained) and a prepaid commission of CU2,545 (CU3,000 – CU455) at the time it accrues the CU3,000 owed to the salesperson. The prepaid commission would be re-characterized as a contract cost asset as each subsequent contract was obtained (Dr. Contract Cost Asset CU455, Cr. Prepaid Commissions CU455). The contract cost asset recognized for each contract (CU455 in this example) would be amortized in accordance with paragraphs 340-40-35-1 and 35-2 [99 and 100].

54. If the entity applies View B, the entire CU3,000 that is accrued is recognized as a contract cost asset (that is, no prepaid commission). The CU3,000 commission

that became payable upon obtaining contract 1 might be disproportionately high compared to the value of contract 1 such that amortizing the contract cost asset based solely on the transfer of goods and services in contract 1 would produce results that are not representationally faithful. In this case, even if the commission is recognized entirely as a contract cost asset at the time the CU3,000 commission is incurred, the entity might reasonably determine that the commission relates to the goods and services that will be transferred in contract 1 *and* future anticipated contracts. When contract 10 is executed and an additional CU2,000 commission is incurred, the entity's accounting for that incremental commission amount may vary depending on the entity's previous determination as to what goods or services the initial CU3,000 commission relates to.

55. In this example, View C might be simpler to apply and produce more intuitive results than View B, but as noted, the staff think either view could be acceptable based on the guidance. The staff note that similar considerations to those in Example 6 would apply to determining recoverability and in subsequently assessing the contract cost asset for impairment, as well as determining the amortization period.

### *Types of costs to capitalize*

*Issue 6: Should entities consider fringe benefits in the assessment of determining the amount of commissions to record as incremental costs (e.g., payroll taxes, pension / 401K match, FICA)*

56. The following three views on this issue have been communicated to the staff:

(a) *View A* – No, as fringe benefits are the result of an allocation of an employee's total benefits and wages, they are not considered part of the total incremental cost of obtaining a contract and should not be capitalized.

(b) *View B* – Yes, fringe benefits should be capitalized as part of the total incremental cost of obtaining a contract if those additional costs are based on the amount of commissions paid.

(c) *View C* – Fringe benefits may be capitalized as part of the total incremental cost of obtaining contracts based on the policy election of the entity.

57. View A would appear to be appropriate only if the fringe benefits are an allocation of costs that would have been incurred whether or not the contract had been obtained (for example, an allocation of company car depreciation costs).

58. View B would appear to be appropriate if the fringe benefits are incurred as a direct result of incurring the commission (for example, payroll taxes or pension costs the entity is required to pay as a result of the commission earned by the employee for obtaining the contract) because they are costs "that would not have been incurred if the contract had not been obtained."

59. View C is not in accordance with the new revenue standard because paragraph 340-40-25-1 [91] states that an entity "*shall* recognize as an asset the incremental costs of obtaining a contract." The entity does not have a policy choice. However, an entity would be able to assess whether the capitalization (or non-capitalization) of fringe benefits is material.

### *Pattern of amortization for contract assets related to multiple performance obligations*

*Issue 7: How should entities determine the pattern of amortization for a contract cost asset that relates to multiple performance obligations that are satisfied over disparate points or periods of time?*

60. Consider the following example:

> Example 8
>
> An entity enters into a contract with two performance obligations for which performance occurs over 2 years. The entity pays a commission to obtain the contract that is required to be capitalized under ASC 340-40 / IFRS 15. The capitalized asset relates to the transfer of goods and services for the entire contract.
>
> The first performance obligation is satisfied at or near contract inception and represents 80% of the total allocable transaction price. The second

> performance obligation (20% of the total allocable transaction price) is satisfied over the term of the contract.
>
> *View A* – Allocate the asset to the individual performance obligations on a relative basis (in proportion to the transaction price allocated to each performance obligation) and amortize the respective portion of the asset based on the pattern of performance for the underlying performance obligation (for example, in this scenario, 80% of the contract cost asset would be amortized at or near inception and the remaining 20% over the contract term).
>
> *View B* – Amortize the single asset using one measure of performance considering all of the performance obligations in the contract. Use a measure that best reflects the "use" of the asset as the goods and services are transferred. Note that this approach may result in a similar pattern of amortization as View A, but without any specific allocation of the contract cost asset to individual performance obligations.
>
> *View C* – Amortize the contract cost asset considering the last delivered performance obligation. Note that depending on the amount capitalized and the profitability of the last delivered performance obligation, an immediate impairment (whole or partial) of the contract acquisition cost asset could occur.

61. Paragraph 340-40-35-1 [99] states:

> "An asset recognized in accordance with paragraph 340-40-25-1 [91] or 340-40-25-5 [95] shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates."

62. It appears that, depending on the specific facts and circumstances, both View A and View B might satisfy this requirement to "mirror" the pattern of transfer of the goods and services to the customer for the contract as a whole. View B may be more operational for some entities since it would not require a relative standalone selling price allocation of the contract cost asset. However, the staff would expect outcomes between View A and View B to be reasonably similar in most cases.

63. It appears that View C is unlikely to be in accordance with the new revenue standard. Amortization in the manner suggested by View C would not reasonably

reflect the pattern in which the goods and services to which the capitalized contract costs relate are transferred to the customer.

64. Stakeholders have further questions about how the amortization pattern would be affected in the above example if the entity anticipates future contracts but the number and timing of satisfaction of the performance obligations in those anticipated contracts is unknown.

65. The staff think that anticipation of future contracts does not fundamentally affect that either View A or View B could be applied. The staff think that either approach can be extended to include the expected profile of the transfer of the goods and services in the specifically anticipated future contracts, so that the pattern of amortization would reflect the revenue profile of the expected transfer of the goods and services in *both* the initial and expected future contracts.

66. The staff also think it is important to remember that most entities currently have processes in place to make estimates about the pattern and timing of amortization or deprecation for other assets that commonly are more significant than capitalized sales commissions (for example, a building, an acquired brand, or a non-compete agreement). The staff think in most cases the effort necessary to properly amortize capitalized sales commissions would not be more than the effort to amortize/depreciate other assets.

67. Finally, the staff think that it is important to remember that the new revenue standard includes guidance about testing capitalized sales commissions for impairment. The staff think that if an entity selects an unreasonable amortization period, then the asset might become impaired.

**Questions for the TRG Members**

1. What are your views on the potential implementation issues in this paper?

2. Do you think the principles in the new revenue standard regarding capitalization of the incremental costs to obtain a contract can be applied in a reasonable manner?

## Appendix A

### *Incremental costs of obtaining a contract*

**340-40-25-1 [91]** 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.

**340-40-25-2 [92]** The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

**340-40-25-3 [93]** 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.

**340-40-25-4 [94]** 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.

### *Costs to fulfil a contract*

**340-40-25-5 [95]** If the costs incurred in fulfilling a contract with a customer are not within the scope of another standard (for example IAS 2 *Inventories*, IAS 16 *Property Plant and Equipment* or IAS 38 *Intangible* A*ssets*), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

(a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example costs relating to 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);

(b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and

(c) the costs are expected to be recovered.

### *Amortization and impairment*

**340-40-35-1 [99]** An asset recognized in accordance with paragraph 340-40-25-1 [91] or 340-40-25-5 [95] shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a) [95(a)].

**340-40-35-2 [100]** An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer 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 with Subtopic 250-10 [IAS 8] on accounting changes and error corrections.

### *Contract modifications*

**606-10-25-13 [21]** If a contract modification is not accounted for as a separate contract in accordance with paragraph 20, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (ie the remaining promised goods or services) in whichever of the following ways is applicable:

(a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 22(b)) is the sum of:

   (i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and

   (ii) the consideration promised as part of the contract modification.

(b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entities measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).

(c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objective of this paragraph.

### *Example 36 – Incremental costs of obtaining a contract*

*Example 36—Incremental Costs of Obtaining a Contract*

**340-40-55-2 [IE189]** An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

| | **CU** |
|---|---:|
| External legal fees for due diligence | 15,000 |
| Travel costs to deliver proposal | 25,000 |
| Commissions to sales employees | 10,000 |
| | --------- |
| Total costs incurred | 50,000 |
| | ===== |

**340-40-55-3 [IE190]** In accordance with paragraph 340-40-25-1 [91], the entity recognizes an asset for the CU10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1 [91], the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

**340-40-55-4 [IE191]** The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3 [93], those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

### *Basis for Conclusions*

**BC297** The Boards decided that 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. The Boards defined the incremental costs of obtaining a contract as the costs that an entity incurs in its efforts to obtain a contract that would not have been incurred if the contract had not been obtained. The Boards acknowledged that, in some cases, an entity's efforts to recognize an asset from incremental acquisition costs might exceed the financial reporting benefits.

Consequently, as a practical expedient, the Boards decided to allow an entity to recognize those costs as expenses when incurred for contracts in which the amortization period for the asset that the entity otherwise would have recognized is one year or less.

**BC298** The Boards considered requiring an entity to recognize all of the costs of obtaining a contract as expenses when those costs are incurred. The Boards observed that, conceptually, an entity may obtain a contract asset as a result of its efforts to obtain a contract (because the measure of the remaining rights might exceed the measure of the remaining obligations). However, because the principle in Topic 606 [IFRS 15] requires an entity to recognize a contract asset and revenue only as a result of satisfying a performance obligation in the contract, the Boards observed that on the basis of that reasoning, the contract asset would be measured at zero at contract inception and any costs of obtaining a contract, therefore, would be recognized as expenses when incurred.

**BC299** Many respondents disagreed with recognizing all costs to obtain a contract as expenses when incurred because those costs meet the definition of an asset in some cases. In addition, they noted the following:

a. Other Topics require some of the costs of obtaining a contract to be included in the carrying amount of an asset on initial recognition.

b. The recognition of the costs of obtaining a contract as expenses would be inconsistent with the tentative decisions in the Boards' projects on leases and insurance contracts.

**BC300** During the redeliberations, the Boards decided that, 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, the Boards observed that recognizing the full amount of a sales commission as an expense at inception of a long-term service contract (when that sales commission is reflected in the pricing of that contract and is expected to be recovered) would fail to acknowledge the existence of an asset.

**BC301** Consequently, the Boards decided that an entity would recognize an asset from the costs of obtaining a contract and would present the asset separately from the contract asset or the contract liability. To limit the acquisition costs to those that clearly can be identified as relating specifically to a contract, the Boards decided that only the incremental costs of obtaining a contract should be included in the measurement of the asset if the entity expects to recover those costs. The Boards decided that determining whether other costs relate to a contract is too subjective.

**BC302** The Boards noted that it might be difficult for some entities to determine whether a commission payment is incremental to obtaining a new contract (for example, payment of a commission might depend on the entity successfully acquiring several contracts). The Boards considered whether to allow an accounting policy election for contract costs under which an entity would have been able to choose to recognize an asset from the acquisition costs or recognize those costs as an expense (with disclosure of the accounting policy election.) The Boards noted that this would have been consistent with previous revenue recognition guidance in U.S. GAAP for public entities. However, the Boards noted that introducing accounting policy elections into the guidance would have reduced comparability and therefore would not have met one of the key objectives of the revenue recognition project to improve comparability in accounting among entities and industries. Consequently, the Boards decided not to allow entities an accounting policy election with respect to contract acquisition costs.

**BC303** The FASB noted that depending on the specific facts and circumstances of the arrangement between an asset manager and the other parties in the relationship, the application of the guidance on incremental costs of obtaining a contract might have resulted in different accounting for sales commissions paid to third-party brokers (that is, in some cases the commission would have been recognized as an asset, while in others it would have been recognized as an expense). The FASB observed that it had not intended the application of Subtopic 340-40 to result in an outcome for these specific types of sales commissions that would be different from applying existing U.S. GAAP. Consequently, the FASB decided to retain the specific cost guidance for investment companies in paragraph 946-605-25-8 which has been moved to Subtopic 946-720, Financial Services—Investment Companies—Other Expenses.

**BC309** The Boards decided that an entity should amortize the asset recognized from the costs of obtaining and fulfilling a contract in accordance with the pattern of transfer of goods or services to which the asset relates. Respondents broadly agreed; however, some asked the Boards to clarify whether those goods or services could relate to future contracts. Consequently, the Boards clarified that in amortizing the asset in accordance with the transfer of goods or services to which the asset relates, those goods or services could be provided under a specifically anticipated (that is, future) contract. That conclusion is consistent with the notion of amortizing an asset over its useful life and with other standards. However, amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.