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Accounting Spotlight
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Background

Did you know that accounting for costs can be one of the more challenging aspects of implementing the new revenue standard? Since the issuance of ASU 2014-09[1] by the FASB almost five years ago, stakeholders have been actively engaged in understanding and operationalizing the requirements of that ASU as subsequently amended and clarified.[2] Given the required adoption dates, most public business entities (PBEs) have already adopted the new revenue standard, and the experiences of those PBEs that have implemented the new standard can provide useful insights into common areas of judgment that may require focus from entities that are still transitioning to the standard. Although the new standard (specifically, the guidance codified in ASC 606[3]) primarily affects the timing and measurement of revenue, the standard's new cost guidance (codified in ASC 340-40) has also proved to be an area in which judgment needs to be applied. Further, the availability of historical data may significantly affect implementation project timelines.

[1] FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

[2] For a full listing of the ASUs that the FASB issued to amend and clarify the guidance in ASU 2014-09, see Section 19.2.2 of Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Cost Accounting Issues

Capitalization of Costs of Obtaining a Contract With a Customer

ASC 340-40 requires entities to capitalize the incremental costs of obtaining a contract with a customer if the costs are expected to be recovered. The new revenue standard defines incremental costs of obtaining a contract as "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." The most common example of an incremental cost of obtaining a contract is a sales commission paid by an entity to its employees. However, an entity should not assume that all types of commissions are capitalizable under the new revenue standard. Rather, an entity must evaluate whether it incurred a cost solely to obtain a contract with a customer (i.e., whether the cost incurred is an incremental cost of obtaining such a contract). Often, an entity can identify an incremental cost of obtaining a contract with a customer by considering the following question:

> *Was an unavoidable obligation to pay an incremental cost incurred as a result of obtaining a contract with a customer*?

While the evaluation of whether a commission is an incremental cost of obtaining a contract with a customer is generally straightforward when the commission is a fixed amount or a percentage of contract value, an entity may need to exercise more judgment if compensation plans are complex. Complex scenarios include situations involving:

- Plans in which the vesting of equity awards is dependent on quotas and maintaining employment.
- Commissions that include service conditions.
- Salaries based, in part, on the employee's prior-year signed contracts.
- Commissions paid in different periods or to multiple employees for the same contract.
- Plans with multipliers or commission tiers.
- Plans with clawback features.

The table below summarizes our general views on whether certain costs are incremental costs of obtaining a contract with a customer and are therefore capitalizable under ASC 340-40.

Type of Cost	Accounting Under ASC 340-40
Fixed employee salaries	Fixed employee salaries are not incremental costs of obtaining a contract with a customer and therefore should not be capitalized even if they are based, in part, on the number of contracts signed in the prior period.
Commissions tied to a service condition	If the employee is required to remain employed with the entity for a specific period before being entitled to a sales commission, the entity should exercise judgment to determine whether the service condition is substantive. If the service condition is deemed to be substantive, a liability may not have been incurred in connection with obtaining a contract with a customer, and some or all of the sales commission may not be an incremental cost of obtaining a contract with a customer. However, if the service condition is deemed to be nonsubstantive, the commission is likely to be an incremental cost of obtaining a contract with a customer.
Bonus payments based, in part, on an employee's sales	If the bonus payments are based on factors other than just an employee's sales (e.g., geography, level, years of employment), they may not be incremental costs of obtaining a contract with a customer.

(Table continued)

Type of Cost	Accounting Under ASC 340-40
Stock-based compensation	Equity awards tied directly to obtaining a contract with a customer may represent an entity's incremental costs of obtaining such a contract. However, significant judgment may be required for the entity to determine whether the costs are incremental costs of obtaining a contract with a customer if vesting of the equity awards is tied to both a service period and the achievement of certain contract thresholds.
Commissions paid to different levels of employees	The new revenue standard does not make a distinction based on the level or function of the employee that receives the commission. For example, in addition to the direct salesperson receiving a sales commission, the salesperson's manager may also receive a commission. If the manager's commission is also an incremental cost of obtaining a contract with a customer, the entity should capitalize the manager's commission in addition to the salesperson's commission.
Commissions subject to a threshold (i.e., tiered commissions)	Certain commission plans may specify that (1) the commission is subject to a cumulative contract threshold or (2) the commission rate changes depending on the number (or cumulative value) of contracts signed. Although the value of the commission changes in tiered structures, the commission in these types of plans is generally still an incremental cost of obtaining a contract with a customer and therefore should generally be capitalized.
Fringe benefits	When fringe benefits or other incremental costs (e.g., payroll taxes, pension contributions, or 401(k) matches) are attributed directly to sales commissions that are determined to be incremental costs of obtaining a contract with a customer, the fringe benefits or other costs also qualify as incremental costs of obtaining such a contract and therefore should be capitalized.
Legal fees and travel costs	Legal fees and travel costs that an entity incurs to negotiate a contract with a customer are generally incurred regardless of whether the contract is obtained (i.e., the costs would still be incurred if the parties decided at the last minute not to execute the contract). Therefore, such costs are not capitalizable.

Because commission and compensation structures can vary significantly between entities, an entity should evaluate its specific facts and circumstances when determining which costs are incremental costs of obtaining a contract with a customer. It is important for an entity to consider whether an obligation to make a payment is solely a result of obtaining a contract with a customer. In addition, it is necessary for an entity to refer to U.S. GAAP outside of the new revenue standard to determine when a liability has been incurred. Upon recognizing a liability, an entity needs to consider whether the corresponding amount should be recognized as an asset in accordance with ASC 340-40-25-1. Further, unlike historical practices, capitalizing incremental costs of obtaining a contract with a customer is not an accounting policy election. That is, such incremental costs *are required* to be capitalized unless the amortization period for the capitalized costs would be one year or less.

Amortization Period for Capitalized Costs of Obtaining a Contract With a Customer

ASC 340-40 requires an entity to amortize capitalized costs of obtaining a contract with a customer "on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates." An entity may need to use significant judgment when identifying "the goods or services to which the asset relates" (i.e., determining the amortization period). When commissions are paid on contract renewals and such commissions are commensurate with the initial commission paid,[4] determining the amortization period may be straightforward. However, in more complex situations, determining the amortization period may require significant judgment. Complex scenarios include situations involving:

- Arrangements in which (1) commissions are not paid on renewal or (2) commissions paid on renewal are not commensurate with the initial commission paid.
- Commission plans in which contract renewals count toward quotas but a salesperson's quota changes each year.
- Entities that (1) have limited customer attrition data or (2) do not have sufficient history to readily determine a customer life.
- Entities that have historically granted concessions to incentivize contract renewals.
- Competitive markets that require significant innovation and investment for entities to attract and retain customers.

In the above situations, an entity will need to use judgment when determining whether the incremental cost it incurred to obtain a contract (or customer acquisition asset) is related to (1) the initial contract and all future contracts with the customer (i.e., the expected customer life) or (2) the initial contract and one or more, but not all, future contracts with the customer (i.e., a period greater than the initial contract term but shorter than the expected customer life). Although an entity will need to use judgment to determine the amortization period of the customer acquisition asset, it may consider the following factors:

- *Incremental costs of obtaining a sale (e.g., commissions) relative to ongoing contract value* — A small commission relative to the value of the contract could suggest that the customer acquisition asset has limited value and that the asset life is relatively short. In contrast, a higher commission payment relative to the contract value (1) could suggest that the entity believes the asset to be of greater value or (2) may be related to anticipated contracts (i.e., future renewals) with the customer.
- *Degree of difficulty in switching service providers or suppliers* — If it is difficult for a customer to switch service providers or suppliers, the customer acquisition asset may have a longer life. Accordingly, the entity may expect that the efforts it performed to acquire the initial contract with the customer will provide it with value over a longer period (i.e., over some or all contract renewals). In contrast, if there are only limited barriers to a customer's ability to switch service providers or suppliers (and there are other service providers or suppliers readily available to the customer), the customer acquisition asset may have a shorter life.
- *Extent to which the product or service changes over the customer life* — Significant changes in the underlying product or service over the customer life may suggest that the life of the customer acquisition asset is shorter than the customer life. That is, the asset may be related to some, but not all, anticipated contracts with the customer. For example, if a customer's decision about whether to renew a contract is influenced by enhancements made to products or services, the activities required to initially obtain the customer may not be related to all anticipated contract renewals with the customer. In contrast, if the same service or product is provided in each renewal period, the customer acquisition asset may be attributed to all anticipated contract renewals (i.e., the customer life).
- *Other customer maintenance activities* — If the entity incurs significant costs (relative to the initial incremental cost incurred) to maintain a customer relationship (e.g., concessions or other incentives), the useful life of the customer acquisition asset could be shorter than the anticipated customer life. However, if only limited costs

[4] The transition resource group for revenue recognition (TRG) discussed this topic at its November 2016 FASB-only TRG meeting and agreed that an entity's evaluation of whether a renewal commission is commensurate with the initial commission paid should be based on the contract value rather than on the level of effort that the entity incurred to obtain the renewal contract.

are required to maintain a customer relationship, the useful life of the customer acquisition asset could extend to all anticipated contracts with the customer (i.e., the customer life). Fulfillment costs would not be considered customer maintenance costs. Only costs that are incremental to transferring the specified goods or services to the customer should be evaluated as costs of maintaining the customer relationship.

The above factors are not all-inclusive or determinative. Accordingly, an entity should consider all relevant facts and circumstances when determining the amortization period for customer acquisition assets.

Implementation Considerations

An entity may consider the following steps to appropriately account for commissions under the new revenue standard:

- Meet with the human resources team to understand the structure of commission plans offered by the entity.
- For each type of commission, evaluate whether the commission is paid solely because a contract with a customer was executed.
- Compare any commissions paid upon contract renewals with commissions paid for initial contracts to determine whether the renewal commissions are commensurate with the initial commissions.

Because the customer acquisition asset needs to be recorded when the new revenue standard is adopted, entities may need to accumulate significant amounts of historical data, depending on the adoption method and whether the new standard is applied to all contracts or only to open contracts, to properly determine the amount of the customer acquisition asset that should be recorded upon adoption.

Where to Find Additional Information

For additional in-depth discussion and analysis of the capitalization and amortization of incremental costs incurred to obtain a contract with a customer, along with other topics related to the new revenue standard, refer to Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*. If you have questions about the new revenue standard or need assistance in interpreting its requirements, please contact any of the following Deloitte professionals:

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